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Corporate Governance: Law and Practice

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Bart Schwartz
Amy L. Goodman
General Editors
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1 Corporate Governance: Law and Practice Dedication

Dedication

Dedication

To Betsy, Ben and Claire, whose inspiration, support and long forbearance have made possible my contribution to this work.

Bart Schwartz

To Ken, Harrison and Laura for their love and support.

Amy L. Goodman



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1 Corporate Governance: Law and Practice About the General Editors

About the General Editors

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Mr. Brown has served as Co-Chairman of the Capital Markets Forum of the International Bar Association's Section on Business Law (1998-2002), Co-Chairman of the Section's Committee on Issues and Trading in Securities (1996-1998) and adjunct faculty member at Columbia Law School. He has also chaired the Committee on Professional Responsibility and the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York.

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Mr. Feller received his law degree from Columbia Law School in 2000. He earned a bachelor of science from Cornell University in 1997. He is admitted to practice in the States of New York and California.

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(May 2002); "Exposing a False Dichotomy: The Implication of the No-Talk Case for the Time/Revlon Double Standard," 2 Del. L. Rev. 179 (2000); "Exorcising the Omnipresent Specter: The Impact of Substantial Equity Ownership on Unocal Analysis," 55 Bus. Law 109 (2000); "Liability of Directors of Acquiring Companies," *Insights* (Nov. 2000); "Can a Board Dilute a Majority Stockholder?," *Corporate Counsel* (Nov., 2000); "The Changing Rules of Takeover Defense," *The Corporate Board* (July/Aug., 2000); "An Appraiser By Any Other Name," *Insights* (May 1999); "The Line Item Veto and Unocal: Can a Bidder Qua Bidder Pursue Unocal Claims Against a Target Corporation's Board of Directors?," 53 Bus. Law 767 (1998).

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Ms. Minow was formerly a Principal of LENS, a \$100 million investment firm that bought stock in underperforming companies and used shareholder activism to increase their value. She was dubbed "the CEO Killer" by Fortune magazine for her record of ousting non-performing CEOs at companies like Sears, American Express, Kodak, and Waste Management and was listed as one of the 30 smartest people in investing in the December 2002 issue of Smart Money magazine. Before LENS, she served as general counsel and then president of Institutional Shareholder Services, Inc., a firm that advises institutional investors on issues of corporate governance, and as an attorney at the Environmental Protection Agency, the Office of Management and Budget, and the Department of Justice. Ms. Minow is a graduate of Sarah Lawrence College and the University of Chicago Law School.

Ms. Minow frequently comments on the financial markets in the press and on television, including on network news broadcasts. She has written more than 200 articles as well as chapters in treatises on executive compensation, annual shareholder meetings, and in the books *Law Stories*, *The Dance of Change*, and *The Financial Services Revolution*. She is co-author with Robert A. G. Monks of three books, *Power and Accountability*, (HarperBusiness 1991), the textbook *Corporate Governance* (Blackwell 1995, 2001, and 2003), and *Watching the Watchers: Corporate Governance for the 21st Century* (Blackwell 1996).

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John F. Olson, a 1964 honors graduate of the Harvard Law School, is a founding partner in Gibson, Dunn & Crutcher's Washington, D.C. office. Mr. Olson has extensive experience in general representation of business organizations as to corporate governance, corporate securities, corporate finance and merger and acquisition matters. He has acted as special counsel for boards of directors and board committees on governance issues and in assessing shareholder litigation, responding to business combination proposals and conducting internal investigations. He also has represented corporations, broker-dealer firms and individuals in defense of Securities and Exchange Commission and other governmental investigations.

In the American Bar Association (ABA), Mr. Olson has just completed a five year term as Chairman of the Business Law Section's Committee on Corporate Governance, as well as a member of the Presidential Task Force on Corporate Responsibility appointed by the President of the ABA. Previously, he was Chairman of the ABA's Committee on Federal Regulation of Securities (1991-1995). He is a member of the Executive Council of the Securities Committee of the Federal Bar Association.

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In 2004, Mr. Olson was identified by *Legal Times* as one of the "10 Leading Securities Attorneys" in the Washington, D.C. area. In 2005, he was named one of the 500 leading lawyers in America by *Lawdragon* and one of the leading corporate governance practitioners in the world by *Legal Media Group*. A frequent lecturer at legal and business seminars, Mr. Olson co-chairs various seminars on an annual basis. He is on the executive committee for the San Diego Securities Regulation Institute and the advisory committee for the Practising Law Institute's Annual Securities Regulation Institute. He is the author of more than 100 articles and a member of the editorial advisory boards for a variety of securities and corporate law publications. Mr. Olson is the co-author of *Director and Officer Liability: Indemnification and Insurance*, published by West Publishing (revised 2002) and has edited several other books on securities law issues. Mr. Olson was the Distinguished Visiting Practitioner in Residence at Cornell Law School in Spring 2003 and is currently an adjunct professor of law at Northwestern University School of Law.

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Mr. Regner joined Debevoise as an associate in 1994 and became a partner in 2002. He received his A.B. from Colgate University in 1988 and his J.D., *summa cum laude*, from the Benjamin N. Cardozo School of Law in 1994, where he was Articles Editor of the *Cardozo Law Review*.

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Ms. Wright is the author or co-author of several publications on corporate and securities law issues, including "SEC Issues Guidance on Form 8-K Amendments," *Insights* (Dec. 2004); and "Inside the SEC: Sarbanes-Oxley Rulemaking

Scorecard," *Insights* (Feb. 2003).

Ms. Wright received her law degree from Georgetown University Law Center in 2002 and her bachelor's degree from Georgetown University in 1998. She is admitted to practice in Virginia and the District of Columbia and is a member of the Business Law Section of the American Bar Association.



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Corporate Governance: Law and Practice

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Publication Information

1 Corporate Governance: Law and Practice Foreword

Foreword

Foreword

As the sixth update of *Corporate Governance: Law and Practice* goes to press, the field of corporate governance is very much in flux. In the wake of the financial crisis of 2008-2009, proposals now pending in Congress and before the SEC, if they come into effect, would create new requirements for corporate boards, new rights for shareholders, and new disclosure requirements for public companies in the areas of corporate governance and executive compensation. More than ever before, they would also federalize the law of corporate governance. Further, along with recent rule changes (such as the amendment of New York Stock Exchange Rule 452 to eliminate broker discretionary voting of uninstructed shares in director elections), they would fundamentally alter the dynamics of the relations between shareholders, boards of directors, and corporate management - the boundaries of that relationship being the central issue in the field of corporate governance.

An excellent report released on August 1, 2009 by the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities thoughtfully examines the roles of the players in the corporate governance arena. Among other important points, it highlights that, contrary to some current rhetoric, stockholders are not the "owners" of the corporation in the sense that a person might own real or tangible property. They are the owners of shares of stock, which, by their terms and under state law, provide specific, carefully delineated rights. By the same token, the buzzword "shareholder democracy" is misleading in its implication that there is a useful analogy between governments that are organized as democracies and the rules and policies governing the relationship between shareholders, boards and managers. As the field of corporate governance evolves, it is important to engage in the kind of painstaking policy analysis that the ABA Report does, and not to fall prey to shibboleths that call for radical transformation of the relationships between state and federal law, private ordering and uniform rules, and the actors in corporate governance, without careful consideration of the policy implications for the efficient and effective functioning of corporations, which should be the ultimate touchstone.

Bart Schwartz
Amy L. Goodman

September 2009



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What's New

1 Corporate Governance: Law and Practice Scope

Scope

HIGHLIGHTS

Release 7A May 2010

Special Release of Chapter 5

Just recently, the author of one of the chapters of our Corporate Governance: Law and Practice publication alerted me to some errors/mistakes that unfortunately made its way into Release 6 of this publication. We are issuing this release, which contains the corrected version of Chapter 5. Apologies for any inconvenience caused and our sincere thanks for your continued patronage.

This special release of Chapter 5 discusses the overall issue of the liability of corporate officers and directors. However, particular attention is placed on this issue in light of the current economic and financial conditions. The author also explores more closely the topic of officer/director indemnification through a number of recent cases such as *In re Citigroup* (Del. Chancery, 2009). "In *Citigroup*, the court dismissed claims against current and former Citigroup directors alleging that they failed adequately to oversee and manage the risks that the company faced from exposure to the problems in the subprime mortgage market in 2007 and 2008, even in the face of alleged "red flags." *In re Citigroup* placed a much higher burden of proof upon plaintiffs to prove director/officer liability. ... However, "the foregoing case(s) also illustrate that, under Delaware law, directors who engage in conduct that amounts to an intentional dereliction of duty or conscious disregard for their responsibilities will not be entitled to exculpation under Section 102(b)(7)."

Additionally, the author provides a more in-depth analysis on the related topic to indemnification--the advancement of legal fees by the corporation to the officer or director. The author uses a number of leading cases, such as *Sun Times Media v. Conrad Black, et al or Bergonzi v. Rite Aid Corp.*, to dissect the rather thorny issue of advancement of legal fees and indemnification."



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Corporate Governance: Law and Practice

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CHAPTER 1 HISTORY AND SOURCES OF CORPORATE GOVERNANCE

1-1 Corporate Governance: Law and Practice 1.syn

AUTHOR: Amy L. Goodman

§ 1.syn Synopsis to Chapter 1: HISTORY AND SOURCES OF CORPORATE GOVERNANCE

§ 1.01 The Agency Problem

§ 1.02 The History of Corporate Governance

[1] State Chartering of Corporations

[2] The Stock Market Crash and the Federal Securities Laws

[3] The Questionable Payments Era

[4] Increasing Shareholder Activism

[5] The Corporate Scandals and the Sarbanes-Oxley Act of 2002

[6] The Financial Crisis

§ 1.03 The Sources of Corporate Governance

[1] State Corporation Law

[2] Federal Securities Laws

[a] The Statutes

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[4] Self-Regulatory Organizations

[5] Best Practices

[a] American Law Institute

[b] American Bar Association

[c] Business Roundtable

[d] Institutional Investors

[e] Post-Enron Scandal Reports

[f] Post-Financial Crisis Reports

Amy L. Goodman n*

FOOTNOTES:

(n1)Footnote *. Travis S. Souza, an associate at Gibson, Dunn & Crutcher LLP, assisted in the preparation of the 2010 supplement of this chapter.



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CHAPTER 1 HISTORY AND SOURCES OF CORPORATE GOVERNANCE

1-1 Corporate Governance: Law and Practice § 1.01

AUTHOR: Amy L. Goodman

§ 1.01 The Agency Problem

Corporations are a key component to a capitalist society as they provide a vehicle to assemble human and financial capital. Their limited liability and perpetual existence are essential to our economy. However, from almost the start of the modern corporation in the 19[th] century, there has been concern about the division between ownership by shareholders and control by management.ⁿ¹ As expressed most eloquently by Columbia Professors Adolph A. Berle and Gardiner C. Means: "the organization under the system of private enterprise has rested upon the self-interest of the property owner".ⁿ² However, if the property owner is no longer involved in the day-to-day management of the enterprise, but, instead, the owners are a widely dispersed group of shareholders, who is to hold the managers accountable? Throughout this century, efforts have been made, through legislation, regulation and otherwise, to address this "agency problem". Today, the agency problem and the respective roles of the board of directors, management, and shareholders are at the heart of the debate concerning corporate governance.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law
 Agency Relationships
 General Overview
 Business & Corporate Law
 Corporations
 General Overview
 Business & Corporate Law
 Corporations
 Directors & Officers
 General Overview
 Business & Corporate Law
 Corporations
 Governing Documents & Procedures
 General Overview
 Business & Corporate Law
 Corporations
 Shareholders
 General Overview

FOOTNOTES:

(n1)Footnote 1. Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932). Even prior to Berle and Means Adam Smith had observed that corporate managers do not watch over "other people's money" with the same vigilance as partners in a private company watch over their own. Adam Smith, *Wealth of Nations*, Vol. 2, p. 741 (Glasgow ed. 1976).

(n2)Footnote 2. Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932).



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CHAPTER 1 HISTORY AND SOURCES OF CORPORATE GOVERNANCE

1-1 Corporate Governance: Law and Practice § 1.02

AUTHOR: Amy L. Goodman

§ 1.02 The History of Corporate Governance

[1] State Chartering of Corporations

States originally provided for chartering of corporations by individual grants, or charters, but by the late 19[th] century most states had shifted to a policy of incorporation by general enabling act under which corporate status could be achieved by following general standards set out in a statute. Over time, limitations on a corporation's capital or its ability to trade and invest in the stock of other corporations also disappeared. It was during this period, as Maine, New York, New Jersey, and finally, Delaware vied for the most flexible statute, that state corporation laws came to be perceived as instruments of competition.ⁿ¹ Over time, these statutes continued to offer widening latitude with respect to corporate activities, capital structure, and internal controls.

This trend was exacerbated during the takeover boom of the 1980s as state legislatures enacted a variety of anti-takeover statutes and Delaware courts issued a number of opinions favorable to management.ⁿ² Beginning in the mid 1980s, however, Delaware courts began issuing opinions limiting the actions of corporate managers and directors when faced with hostile bids.ⁿ³ Later, in the wake of the corporate scandals beginning in 2001, and the enactment of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"),ⁿ⁴ Delaware courts issued a number of opinions signaling that they would be looking more closely and more critically at questions of director independence, good faith and due care.ⁿ⁵ One of the most notable cases, in this regard, involved the compensation, particularly the severance, paid to an executive of The Walt Disney Co. In the first lower court decision, Chancellor Chandler noted that courts rarely impose liability on directors for conduct that is merely negligent or even grossly negligent, but suggested that, in this case, the directors had "failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders".ⁿ⁶ Subsequently, both the Delaware Chancery Courtⁿ⁷ and the Delaware Supreme Courtⁿ⁸ found that none of the directors had breached his fiduciary duties.ⁿ⁹ Similarly, in a 2006 decision, the Delaware Supreme Court affirmed the so-called *Caremark* ⁿ¹⁰ standard and held that directors can be held liable based on alleged failures to satisfy their oversight responsibility only if: (1) the directors fail to implement any reporting or information system or controls;ⁿ¹¹ or (2) having implemented such system or controls, consciously failed to monitor or oversee its operations thus disabling them themselves from being fully informed of risks or problems requiring their attention.ⁿ¹² More recently, in a February 2009 opinion, the Delaware Chancery Court reaffirmed that the business judgment rule is the guiding standard by which to analyze board actions and that Delaware

courts will provide deference to decisions made in good faith, even if those decisions appear "wrong" in hindsight.ⁿ¹³ On the other hand, some Delaware judges have spoken out about the importance of directors' fulfilling their responsibilities to the companies they serve and their shareholders.ⁿ¹⁴

In the past decade, state corporation statutes continued to evolve as shareholder activism increased. For example, in response to a growing shareholder interest in shifting from a plurality to a majority voting standard in director elections, several states amended their corporation laws to facilitate the adoption of a majority voting standard for the election of directors. In addition, as the debate surrounding shareholder access to proxy materials heightened in 2009, Delaware amended its corporation statute to expressly allow a corporation to adopt bylaws permitting shareholder access. In North Dakota, the state legislature went even further and enacted the nation's most shareholder-friendly corporation statute. That statute is optional for companies incorporated in North Dakota and provides for, among other things, majority voting in director elections, advisory shareholder votes on executive compensation, proxy access, and the separation of the roles of chairman of the board and chief executive officer.

[2] The Stock Market Crash and the Federal Securities Laws

The 1929 stock market crash exposed egregious examples of market manipulation, insider trading, and corporate wrongdoing. One of President Franklin Roosevelt's first acts in March 1933 was to send a message urging the enactment of a law on the issuance of securities.ⁿ¹⁵ This was followed by the commencement of the Pecora investigation,ⁿ¹⁶ which ultimately led to the passage of the Securities Act of 1933 ("1933 Act")ⁿ¹⁷ and the Securities Exchange Act of 1934 ("1934 Act").ⁿ¹⁸ Significantly, Congress opted for a disclosure approach as the foundation of the federal securities laws.ⁿ¹⁹ Over the years, as discussed below, the Securities and Exchange Commission ("SEC") has shown varied levels of interest in corporate governance matters. It has used its public voiceⁿ²⁰ and its enforcement authority to, among other things, demand changes in corporate boards, including the formation of audit committees,ⁿ²¹ and has commenced investigations and issued reports describing failures of corporate governance.ⁿ²² It also used its rulemaking authority to require greater disclosure concerning boards of directors, their committees and their processes.ⁿ²³

[3] The Questionable Payments Era

The corporate governance movement took on new impetus in response to revelations of questionable payments--both illegal corporate campaign contributions and overseas bribery--that certain U.S. corporations had made during the 1970s and the SEC's investigation of such practices.ⁿ²⁴ In its report to Congress on such practices in 1976, the SEC noted that "[t]he almost universal characteristic of the cases ... has been the apparent frustration of our system of corporate accountability...".ⁿ²⁵ The report went on to point out that, with only a single exception, such payments occurred at companies without audit committees, with an audit committee that had only been operational for part of the period in which the misconduct occurred, or with an audit committee that was not wholly independent of management. Many of the SEC's settlements with companies involved in questionable payments cases required companies to establish a committee of independent directors to look into these practices.ⁿ²⁶

Congress responded to these revelations with the enactment of the Foreign Corrupt Practices Act of 1977 ("FCPA").ⁿ²⁷ While much attention has focused on the anti-bribery portion of the FCPA, it also includes an important provision relating to corporate governance--Section 13(b)(2) to the 1934 Act, which generally requires every SEC-reporting company to keep accurate books and records and to devise and maintain an adequate system of internal accounting controls. The Sarbanes-Oxley Act enhanced these requirements.ⁿ²⁸

It was also during this period that Congress focused attention on federal chartering of corporations. Ralph Nader and others called for federal chartering of corporations.ⁿ²⁹ Professor William Cary of Columbia Law School called for federal minimum standards for multi-state and multinational corporations, which he believed should be regulated at the national level.ⁿ³⁰ Both the House of Representativesⁿ³¹ and the Senate held hearings,ⁿ³² but there was little

Congressional interest in legislation in this area.ⁿ³³

Responding to these developments and others, in 1977 the SEC initiated a broad re-examination of its rules relating to shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally.ⁿ³⁴ After holding hearings throughout the country, the SEC adopted several amendments to its proxy rules requiring, among other things, (1) enhanced disclosure concerning the structure and functioning of boards of directors and their committees,ⁿ³⁵ and (2) a new form of proxy card, which permitted shareholders to vote on director nominees.ⁿ³⁶ In September 1980, the Commission also authorized issuance of a Staff Report on Corporate Accountability ("1980 Staff Report"), which addressed the roles of shareholders, boards of directors and others in the corporate accountability process and evaluated the efficacy of these accountability mechanisms.ⁿ³⁷ The 1980 Staff Report also included a further agenda for Commission action, as well as recommendations for reforms in the private sector.ⁿ³⁸ Nevertheless, the election of Ronald Reagan in November 1980 and the resulting deregulatory environment in Washington, D.C. caused the abandonment of most of the follow-on recommendations of the 1980 Staff Report.

[4] Increasing Shareholder Activism

A number of corporate failures in the late 1980s and early 1990s, combined with institutional investor frustration left over from the takeover boom of the 1980s, sparked shareholder activism in the early 1990s. By then, many institutional investors had "begun to look to boards of directors to provide a more independent review of corporate performance, direction and strategy."ⁿ³⁹ It was during this period that the boards of directors of some very large companies, including General Motors and IBM, responded to shareholder concerns and replaced incumbent management with new managers. So, too, in 1992, the SEC substantially revised its proxy rules to give shareholders substantial freedom to communicate privately among themselves, as well as to express their views publicly, on corporate governance matters.ⁿ⁴⁰

Throughout the 1990s, institutional investors continued to press for greater influence over the companies in which they invested. Shareholder proposals were put forth in increasing numbersⁿ⁴¹ and "just vote no" campaigns, in which institutional investors urged the withholding of votes from all or particular directors,ⁿ⁴² intensified. The California Public Employees Retirement System ("CalPERS") and Teachers Insurance and Annuity Association/College Retirement Equities Fund ("TIAA-CREF") enhanced their role as activist shareholders, devoting significant attention to the impact of corporate governance practices on the companies in which they invested.ⁿ⁴³

In April 2003, the SEC undertook a review of the process for the nomination and election of corporate directors.ⁿ⁴⁴ On at least two previous occasions, the SEC had considered giving shareholders greater access, but had abandoned the idea.ⁿ⁴⁵ Its proposed rule would give major, long-term shareholders access to company proxy materials to nominate directors where "objective criteria" indicate that shareholders' views were not adequately being taken into account.ⁿ⁴⁶ The proposals generated great support in the institutional investor community and a firestorm of protestⁿ⁴⁷ from many in the business and legal communities who asserted that the proposed rule would improperly intrude on matters traditionally reserved for regulation by the states.ⁿ⁴⁸ Further action on the rule appeared unlikely and the institutional investor community shifted its focus to state law changes in the voting standards in director elections.ⁿ⁴⁹ However, in September 2006, the U.S. Court of Appeals for the Second Circuit in a decision involving the SEC's shareholder proposal rule, Rule 14a-8, reignited the debate over shareholder access.ⁿ⁵⁰ The court rejected the SEC's long-standing interpretation of a provision of Rule 14a-8 that permitted companies to exclude from their proxy materials shareholder access proposals as shareholder proposals that "relate to an election".

The SEC subsequently adopted a proposal reaffirming the SEC's historical position that such shareholder access proposals may be excluded from company proxy statements under Rule 14a-8. That proposal, adopted on December 6, 2007, amended Rule 14a-8 to clarify that a shareholder proposal may be excluded if it relates to procedures that would result in a contested election of directors either in the year in which the proposal is submitted or in a subsequent year.ⁿ⁵¹

As a result of the 2007 amendment, the shareholder access debate again shifted to state law. In April 2009, Delaware amended its corporation statute to expressly allow a corporation to adopt bylaws permitting shareholder access to company proxy materials. The new statute allows a company's bylaws to include conditions on such access, including minimum stock ownership and duration of ownership by the nominating shareholder, a limit on the number or proportion of directors that may be nominated, and the preclusion of nominations by persons who have acquired a certain percentage of stock ownership. At the same time, Delaware also amended its corporation statute to permit a corporation's bylaws to provide for the reimbursement of expenses incurred by a shareholder that solicits proxies in connection with director elections. The state law changes regarding shareholder access are likely to spread beyond Delaware. In fact, the American Bar Association is actively considering amending the Model Business Corporation Act (the "MBCA"), which has been adopted in more than 30 states, to address this issue.

The shareholder access issue also has been revitalized at the federal level. In May 2009, the SEC approved the publication of proposed amendments to the SEC's proxy rules to permit shareholder access to nominate directors in a company's proxy materials. The proposals include: (1) a federal proxy access right that would preempt state law and a company's charter and bylaws; and (2) an amendment to Rule 14a-8 to permit proxy access shareholder proposals.

In addition to their focus on shareholder access, shareholder activists have turned their attention to executive compensation, which they view as a mirror into the boardroom. They have submitted an increasing number of shareholder proposals on executive compensation topics, including pay for performance, compensation consultant independence and an advisory vote on compensation. The latter subject--a shareholder advisory vote on compensation--has been the subject of numerous shareholder proposals. During 2008, a total of 74 shareholder proposals seeking annual advisory votes averaged 41.5 percent of the votes cast.ⁿ⁵² Of these proposals, 11 received a majority vote of the shareholders. In the following proxy season, as of November 2009, 75 such proposals went to shareholder vote, receiving an average of 45.9 percent support, with more than 20 receiving a majority vote.ⁿ⁵³ In addition, as of November 2009, at least 23 companies had voluntarily agreed to provide shareholders with an annual advisory vote on compensation, including six companies that held an advisory vote in 2008.

In April and May 2009, the United Brotherhood of Carpenters Pension Fund introduced a new shareholder proposal to the executive compensation debate when it sent a triennial executive pay vote proposal to 20 public companies. The proposal seeks shareholder advisory votes on executive pay as a whole as well as three aspects of such pay every three years, as opposed to the annual votes sought by previous proposals. In addition, the proposal requests a forum for the compensation committee to engage with shareholders. In this regard, Pfizer Inc. and Prudential Financial, Inc. have agreed to hold advisory votes every two years while Microsoft Corp. is doing so every three years.ⁿ⁵⁴

The subject of shareholder advisory voting on compensation also has received Congressional attention. On February 17, 2009, the American Recovery and Reinvestment Act of 2009 ("ARRA"), commonly referred to as the stimulus bill, was enacted. ARRA imposes certain executive compensation requirements on companies receiving assistance under the U.S. Treasury Department's Troubled Assets Relief Program ("TARP"). In particular, all institutions that receive or have received government assistance under TARP are required to permit their shareholders to vote on executive compensation. In addition, Congress has attempted to legislate more broadly. As of November 2009, Congress was considering several pieces of legislation that would require all public companies to hold an annual advisory vote on executive compensation.ⁿ⁵⁵ In particular, on November 10, 2009, U.S. Senator Christopher Dodd introduced a discussion draft of the "Restoring American Financial Stability Act of 2009" that would mandate separate annual non-binding shareholder votes to approve the compensation of named executive officers.

[5] The Corporate Scandals and the Sarbanes-Oxley Act of 2002

The corporate implosions of 2001 and 2002--Enron, WorldCom and Adelphia, to name only a few--created a perceived corporate governance crisis and, in July 2002, resulted in the speedy passage of the Sarbanes-Oxley Act. The haste with

which Congress enacted the Sarbanes-Oxley Act left little time for Congressional consideration of its implications for the state and federal roles in the regulation of corporate governance. The Sarbanes-Oxley Act made significant revisions to the federal securities laws and enhanced the role of the SEC in certain corporate governance matters. It marked a shift to more regimented federal regulation of corporate governance (as distinguished from the more flexible approach of state corporate law).ⁿ⁵⁶ The corporate scandals also caused the stock exchanges and NASDAQⁿ⁵⁷ to undertake a broad re-examination of their listing standards.ⁿ⁵⁸ The listing standards that resulted have given these self regulatory organizations a broader role in corporate governance matters.ⁿ⁵⁹

[6] The Financial Crisis

The historic financial crisis that the United States entered into in late 2007 is likely to have a lasting impact on corporate governance due to the perception that corporate governance failures contributed in part to the problems experienced by a number of financial institutions. In particular, there has been an increased focus on risk management. In addition, the current financial crisis has put the spotlight on executive pay. The Emergency Economic Stabilization Act of 2008 ("EESA"), which was enacted on October 3, 2008 in response to the financial crisis, and was modified on February 17, 2009 by the ARRA, contains several executive compensation provisions. These provisions limit certain incentive compensation arrangements for senior executives, restrict tax deductions for executive compensation and "golden parachute" payments, and provide for the recovery (or "clawback") of executive compensation paid on the basis of financial information that is later proven to be materially inaccurate.

While, EESA and ARRA apply only to participating financial institutions, Congress has indicated a willingness to regulate corporate governance beyond the financial sector. In June 2009, U.S. Representative Gary Peters introduced the "Shareholder Empowerment Act of 2009." More recently, Senator Dodd introduced the discussion draft discussed above. Among other things, both proposed bills would require annual pay votes, independent board chairs, declassified boards, and majority voting in director elections.ⁿ⁶⁰

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law
 Corporations Formation General Overview
 Business & Corporate Law
 Corporations Governing Documents & Procedures General Overview
 Business & Corporate Law
 Corporations Shareholders Meetings & Voting
 Voting Shares General Overview
 Securities Law Additional Offerings & the Securities Exchange Act of 1934
 General Overview
 Securities Law Additional Offerings & the Securities Exchange Act of 1934
 Issuer Recordkeeping & Reporting
 Foreign Corrupt Practices Act
 Securities Law Additional Offerings & the Securities Exchange Act of 1934
 Issuer Recordkeeping & Reporting
 Sarbanes Oxley Act
 Securities Law Initial Public Offerings & the Securities Act of 1933
 General Overview

FOOTNOTES:

(n1)Footnote 1. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L.J.* 663 (1974).

(n2)Footnote 2. See, e.g., *Del. Code Ann. tit. 8, § 203* (2009) and N.Y. Bus. Corp. § 912(a) (2009); *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985) (upholding the validity of a "poison pill" plan).

(n3)Footnote 3. See, e.g., *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) .

(n4)Footnote 4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., 29 U.S.C.).

(n5)Footnote 5. See Meredith M. Brown & William D. Regner, *What's Happening to the Business Judgment Rule?* Insights, Aug. 2003, at 2.

(n6)Footnote 6. *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003) . For further discussion of this case, *see, e.g.*, §§ 10.03 and 16.01[5] below.

(n7)Footnote 7. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005) .

(n8)Footnote 8. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006) .

(n9)Footnote 9. For further discussion of this case, *see, e.g.*, §§ 10.03 and 16.01[5] below.

(n10)Footnote 10. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) .

(n11)Footnote 11. *See ATR-Kim Eng Fin. Corp. v. Araneta, C.A. No. 489, 2006 Del. Ch. LEXIS 215 (Dec. 21, 2006)* for the first decision to impose liability on a *Caremark* claim on the basis that no reporting system whatsoever was in place.

(n12)Footnote 12. *Stone v. Ritter, No. 93, 2006, 911 A.2d 362 (Del. 2006)*.

(n13)Footnote 13. *In re Citigroup Inc. Shareholder Litig., No. 3338-CC, 2009 Del. Ch. LEXIS 25 (Feb. 24, 2009)*

(n14)Footnote 14. *See, e.g.*, Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 *Bus. Law.* 1371 (2002) (Strine is a Vice Chancellor on the Delaware Court of Chancery); *What's Wrong with Executive Compensation?: A Roundtable Moderated by Charles Elson*, *Harv. Bus. Rev.* 68 (Jan. 2003) (including comments of E. Norman Veasey, former Chief Justice of the Supreme Court of Delaware).

(n15)Footnote 15. *See* Louis Loss & Joel Seligman, *Securities Regulation* 170 (1989).

(n16)Footnote 16. Senate Banking and Currency Committee 1932-34 investigation of stock exchange practices, popularly known as the Pecora hearings. *See* Louis Loss & Joel Seligman, *Securities Regulation* 202 (1989).

(n17)Footnote 17. Securities Act of 1933, 15 *U.S.C.* §§ 77a-77aa.

(n18)Footnote 18. Securities Exchange Act of 1934, 15 *U.S.C.* §§ 78a-78mm.

(n19)Footnote 19. *See* Louis D. Brandeis, *Other People's Money and How the Bankers Use It* 92 (1914) ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman".); *see also Santa Fe Indus. v. Green*, 430 *U.S.* 462, 477-78 (1977) (emphasizing the 1934 Act's "philosophy of full disclosure").

(n20)Footnote 20. *See, e.g.*, Address of Harold Williams, Jan. 18, 1978; SEC Chairman William Donaldson, Remarks from Director's College, Stanford University Law School (June 20, 2004); Commissioner Cynthia Glassman, Board Independence and the Evolving Role of Directors, Address delivered at the 26th Annual Conference on Securities Regulations and Business Law Problems (Feb. 20, 2004).

(n21)Footnote 21. SEC Accounting Series Release No. 19 (Dec. 5, 1940).

(n22)Footnote 22. *See, e.g.*, The Financial Collapse of the Penn Central Company, Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, Committee on Interstate and Foreign Commerce, U.S. House of Representatives (1972).

(n23)Footnote 23. *See, e.g.*, Schedule 14A Item 7, 17 *CFR* § 240.14a-101.

(n24)Footnote 24. *See* SEC, Report on Questionable and Illegal Corporate Payments and Practices, Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2nd Sess. (Comm. Print 1976) [hereinafter 1976 Staff Report];

Staff Report on Corporate Accountability, Senate Comm. On Banking, Housing and Urban Affairs, 96th Cong, 2nd Sess. (Comm. Print 1980).

(n25)Footnote 25. 1976 Staff Report at a.

(n26)Footnote 26. 1976 Staff Report at 4 (noting that in 13 out of 14 prosecutions from 1974-75 for illegal foreign and domestic payments, the consent decrees required the companies "to establish a special review committee, composed of independent members of its board of directors").

(n27)Footnote 27. Foreign Corrupt Practices Act of 1977, *15 U.S.C. §§ 78dd-1-78dd-3 (2000)*.

(n28)Footnote 28. *See § 14.02(2)(d) below.*

(n29)Footnote 29. Ralph Nader, Mark Green & Joel Seligman, *Constitutionalizing the Corporation: The Case for the Federal Chartering of Giant Corporations* (1976).

(n30)Footnote 30. *See* William L. Cary, *Federalism and Corporation Law: Reflections upon Delaware*, 83 *Yale L.J.* 663 (1974); William L. Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 *Bus. Law.* 1101 (1974).

(n31)Footnote 31. Report by the House Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce (1976).

(n32)Footnote 32. Senate Subcommittee on Citizen's and Shareholders Rights and Remedies (1977).

(n33)Footnote 33. The SEC also "never supported federal legislation that would have changed to any degree the duties or structure of board of directors". Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* 545 (3d ed. 2003).

(n34)Footnote 34. SEC Release No. 34-13482 (Apr. 28, 1977).

(n35)Footnote 35. SEC Release No. 34-15384 (Dec. 6, 1978).

(n36)Footnote 36. SEC Release No. 34-16356 (Nov. 21, 1979).

(n37)Footnote 37. *See* SEC, Staff Report on Corporate Accountability, Sen. Comm. On Banking, Housing and Urban Affairs, 96th Cong., 2nd Sess. (Comm. Print 1980).

(n38)Footnote 38. *See* 1980 Staff Report at 57-69.

(n39)Footnote 39. Robert A. G. Monks & Nell Minow, *Corporate Governance* 153 (1995).

(n40)Footnote 40. *See* SEC Release No. 34-31326 (Oct. 16, 1992).

(n41)Footnote 41. *See* Practising Law Institute, *The Growing Importance of Institutional Investors and Equity Analysts for the M & A Agenda*, 973 *PLI/Corp.* 567, 577 (1997) (discussing the increase in governance-related shareholder proposals by institutional investors during the 1990s).

(n42)Footnote 42. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 *Stan. L. Rev.* 857 (1993).

(n43)Footnote 43. *See, e.g.,* Willard T. Carleton, James M. Nelson & Michael S. Weisbach, *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF*, 53 *J. Fin.* 1335 (1998).

(n44)Footnote 44. Securities and Exchange Commission Division of Corporation Finance, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors (2003).

(n45)Footnote 45. See Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess., at 17-19 (1943) (testimony of Chairman Gavson Purcell; SEC Release No. 34-3347 (Dec. 18, 1942); SEC Release No. 34-13482 (Apr. 28, 1977). SEC Release No. 34-14970 (July 18, 1978); SEC Release No. 34-15384 (Dec. 6, 1978).

(n46)Footnote 46. SEC Release No. 34-48626 (Oct. 14, 2003). See §§ 2.01[4] and 8.03[1][d] below for further discussion of the proposed rule.

(n47)Footnote 47. Over 13,000 comment letters were submitted. See § 8.03[1][d] below.

(n48)Footnote 48. See Business Roundtable December 22, 2003 comment letter at 45, SEC File No. S7-19-03.

(n49)Footnote 49. See § 2.01[4] and § 8.03[1][d][iii] below.

(n50)Footnote 50. *American Federation of State, County and Municipal Employees (AFSCME) Employees Pension Plan v. American International Group Inc.*, 462 F.3d 121 (2d Cir. 2006).

(n51)Footnote 51. See Shareholder Proposals Relating to the Election of Directors (December 6, 2007).

(n52)Footnote 52. RiskMetrics Group, 2009 Proxy Season Report Card: Results as of Nov. 1, 2009, available at http://www.riskmetrics.com/knowledge/proxy_season_scorecard_2009 (last visited Nov. 8, 2009).

(n53)Footnote 53. *Id.*

(n54)Footnote 54. See Press Release, Pfizer Inc., "Pfizer's Board Of Directors Approves Shareholder Advisory Vote On Executive Compensation" (Oct. 29, 2009); Press Release, Prudential Financial, Inc., "Prudential Financial, Inc. Board of Directors Adopts Non-Binding "Say on Pay" Shareholder Vote" (Oct. 13, 2009); Microsoft Corp., Proxy Statement, at 39 (Sept. 29, 2009).

(n55)Footnote 55. On July 31, 2009, the U.S. House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of 2009, which would require all public companies to hold an annual advisory vote on executive compensation. If approved by the Senate and signed into law, these shareholder advisory votes would apply to all proxy statements filed 6 months after the SEC issues final implementing rules. In addition, several Congressmen proposed legislation during the Spring of 2009 that call for, among other corporate governance reforms related to executive compensation advisory votes at all public companies, including (i) Senator Richard Durbin--the Excessive Pay Shareholder Approval Act; (ii) Senators Charles Schumer and Maria Cantwell--the Shareholder *Bill of Rights* Act of 2009; (iii) Representative Gary Peters--the Shareholder Empowerment Act of 2009, and (iv) Senator Christopher Dodd--a discussion draft of the Restoring American Financial Stability Act of 2009. As of November 12, 2009, none of these bills have made it out of the committee process.

(n56)Footnote 56. See William B. Chandler, III and Leo Strine, Jr., *Views From the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953 (2003).

(n57)Footnote 57. The National Association of Securities Dealers (the "NASD") owns and operates the NASD Automated Quotation system (the "NASDAQ").

(n58)Footnote 58. This was done at the urging of then SEC Chairman Harvey Pitt. See Letter from Harvey L. Pitt, Chairman, SEC, to Chairmen, NYSE & NASDAQ (Feb. 13, 2002).

(n59)Footnote 59. *See* discussion at §§ 6.02, 8.02, 9.02 and 10.04 below .

(n60)Footnote 60. On November 4, 2009, the House Financial Services Committee passed the Investor Protection Act which, among other things, provides for a comprehensive study of the entire securities industry, increases the SEC's enforcement powers and funding, creates a whistleblower bounty program, gives the SEC power to bar mandatory arbitration, and imposes a fiduciary duty standard on all financial intermediaries. As of November 2009, this bill had not been considered by the full U.S. House of Representatives.



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Corporate Governance: Law and Practice

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CHAPTER 1 HISTORY AND SOURCES OF CORPORATE GOVERNANCE

1-1 Corporate Governance: Law and Practice § 1.03

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§ 1.03 The Sources of Corporate Governance

[1] State Corporation Law

Corporations are established under state corporation statutes, which generally prescribe the legal duties and responsibilities of their boards of directors,ⁿ¹ enumerate rights of stockholders,ⁿ² and include provisions relating to mergers, acquisitions and asset sales,ⁿ³ among other matters. Because corporate law has historically been a creature of state law, state judges (especially in Delaware) have also played an important role in defining the legal duties and responsibilities of directors. For example, the "business judgment rule" (a judge-made doctrine) pursuant to which courts afford substantial deference to the business decisions, made in good faith and after due diligence and deliberation, of disinterested and independent directors, has contributed significantly to the development of modern corporate governance.ⁿ⁴ In 2005, with the failure of the SEC to adopt its shareholder access rule, state corporation law began to assume new importance to institutional investors.ⁿ⁵ So too, recent Delaware court decisions in *Disney*,ⁿ⁶ *Oracle* ⁿ⁷ and *Integrated Health* ⁿ⁸ have focused greater attention on state corporation law.

State legislators also have responded to the debate surrounding majority voting in director elections. Historically, most U.S. public companies have utilized a plurality voting standard in director elections. However, in 2004, several labor unions and other shareholder groups began to broadly advocate that companies adopt a majority vote standard in uncontested director elections, in order to demonstrate directors' accountability to shareholders. As this debate grew in the 2000s, several states responded by amending their corporation statutes to facilitate majority voting in board elections.ⁿ⁹

In addition, state corporate law and its relationship to the federal proxy rules was the subject of extensive discussion at the roundtables on the proxy process the SEC held in May 2007.ⁿ¹⁰ The resulting proxy access proposals,ⁿ¹¹ and the rule amendment that subsequently was adoptedⁿ¹² also draw heavily on state law. Most recently, in April 2009, Delaware addressed proxy access by amending its corporation statute to expressly allow a corporation to adopt bylaws providing for shareholder access and reimbursement of shareholder costs in proxy contests.ⁿ¹³

[2] Federal Securities Laws

[a] The Statutes

The primary federal securities laws concerning public companies, the 1933 Act and the 1934 Act, are principally disclosure-based statutes.ⁿ¹⁴ They give the SEC authority to require publicly traded companies to include specified information in public filings and otherwise to disclose certain information to investors and shareholders, all with the purpose of permitting shareholders to make investment and voting decisions with accurate and complete information. Nevertheless, since its creation in 1934, the SEC has played a role in the corporate governance of publicly traded companies beyond just mandating disclosure requirements. In an area particularly relevant to corporate governance, Congress gave the SEC authority to regulate the disclosures and processes that public companies follow when they solicit proxies.ⁿ¹⁵ Nevertheless, there is a distinction between imposing disclosure and procedural requirements and engaging in substantive regulation of corporation governance.ⁿ¹⁶ In 1990, the U.S. Circuit Court of Appeals addressed this distinction in *Business Roundtable v. SEC*.ⁿ¹⁷ The court explained that "state corporate law ... regulates the distribution of powers among the various players in the process of corporate governance."ⁿ¹⁸ This distinction also was the subject of intense focus in the SEC's director election rulemaking in 2003, 2004, and 2007, as described above, and has been raised as an issue in connection with SEC rulemaking in 2009.ⁿ¹⁹ However, as noted above, pending legislation would address this issue by giving the SEC express authority to regulate proxy access.

The Sarbanes-Oxley Act generally continues the traditional disclosure pattern of the federal securities laws, but it also gives the SEC a somewhat enhanced role in the substantive regulation of corporations. Nevertheless, this enhanced role should not be overstated. While the Sarbanes-Oxley Act has focused attention on corporate governance issues, its provisions primarily relate to accounting and disclosure matters. It does prohibit loans to executive officers and directors,ⁿ²⁰ requires certifications by CEOs and CFOs of their responsibility for financial reports,ⁿ²¹ requires managements to assess and report on internal controls,ⁿ²² and contains requirements concerning audit committees.ⁿ²³ The audit committee provisions, however, are implemented, for the most part, through rules of the self-regulatory organizations.

[b] SEC Rulemaking

The SEC has long required disclosure of information about the management and boards of directors of public companies so that investors and shareholders can make informed investment and voting decisions.ⁿ²⁴ Since the 1970s, it also has required increased disclosure about the composition and functioning of boards of directors and their committees. These requirements, in combination with the self-regulatory organization listing standards and best practice guidance, have had an important impact on the structure and functioning of boards of directors.

As part of the broad re-examination of its rules relating to corporate governance in the late 1970s,ⁿ²⁵ the SEC required companies to disclose whether their boards of directors have standing nominating, audit, and compensation committees, or committees performing similar functions.ⁿ²⁶ These rules also require companies to identify the members of each such committee, the number of meetings held by the committee, and the functions that each such committee performs.ⁿ²⁷ The SEC had proposed to require identification of each director as "management," "affiliated non-management" or "independent"ⁿ²⁸ but, in light of commentators' concerns about such labeling, the Commission did not adopt this requirement. It was not until 2003, when the self-regulatory organizations adopted new corporate governance listing standards, that companies were required to make disclosures concerning the "independence" of their directors.ⁿ²⁹ And, in 2006, the SEC adopted new rules requiring greater disclosure about the relationships that the board of directors considers in determining whether a director is independent.ⁿ³⁰

Other SEC rules also have contributed to the establishment of board committees other than audit committees. For example, the rules under Section 16(b) of the 1934 Act permit a committee of two or more "non-employee directors" to approve certain non-discretionary equity grants from a company to its officers and directors, and thus to exempt such transactions from the short-swing trading prohibitions of Section 16(b) of the 1934 Act; that committee often is the compensation committee.ⁿ³¹ Similarly, in 1992, the SEC began requiring companies' annual proxy statements to include a compensation committee report.ⁿ³² In addition, SEC rules adopted in 2003 have encouraged the

establishment of, and required more extensive disclosure regarding, nominating committees and the processes they follow with respect to the nomination of directors.ⁿ³³

SEC rules implementing provisions of the Sarbanes-Oxley Act also have significant corporate governance implications. For example, several new rules affect the relationship between a company's management, outside auditors, and the audit committee,ⁿ³⁴ while others have an impact on the composition of audit committees.ⁿ³⁵ Still other rules affect the relationship between companies' management and boards of directors and their inside and outside counsel.ⁿ³⁶ Moreover, rules of the Public Company Accounting Oversight Board ("PCAOB"), which was created to oversee the accounting professions as part of the Sarbanes-Oxley Act, further influence the functioning of audit committees.ⁿ³⁷

[c] SEC Enforcement

The SEC has often used its enforcement authority under the federal securities laws to effectuate corporate governance changes through the issuance of reports of investigations,ⁿ³⁸ settled enforcement actions, and otherwise. As early as 1940, following its investigation of the McKesson and Robbins Drug Company scandal, the SEC recommended the establishment of board audit committees as a means of improving financial disclosure.ⁿ³⁹ In the early 1970s, following the bankruptcy of Penn Central, the SEC issued a report critical of the role of the directors, noting that they had not received or requested budget or cash flow information needed to understand the financial condition of the company.ⁿ⁴⁰ It concluded that the directors had permitted management to operate without any effective review or control. In subsequent reports, including one involving W.R. Grace & Co., the SEC has emphasized the important role of boards of directors in ensuring that shareholders receive accurate and complete disclosure.ⁿ⁴¹

So too, in settling enforcement actions, companies have agreed to implement substantive corporate governance changes. For example, as early as the 1970s, Mattel agreed to appoint and maintain a board of directors composed of a majority of unaffiliated directors,ⁿ⁴² and Ormand Industries and Potter Instruments each agreed to establish audit committees.ⁿ⁴³ In settling an enforcement case in 2004, Parmalat Finanziaria S.p.A. agreed to amend its bylaws to provide, among other things, that a majority of its board be composed of independent directors and that the positions of chairman and managing director not be held by the same person.ⁿ⁴⁴ The SEC also has indicated that it will look to a company's "tone at the top" and its compliance procedures in determining whether to take enforcement action.ⁿ⁴⁵

[d] SEC "Jawboning"

Historically, many chairmen, commissioners and staff members of the SEC have used their positions to speak out about corporate governance practices. During the questionable payments era of the 1970s, then-SEC Chairman Roderick Hills voiced his concern that "too many boards are dominated by insider directors" and that "[w]hat is missing on too many boards ... is a truly independent character that has the practical capacity to monitor and change management."ⁿ⁴⁶ His successor, Harold Williams, gave a series of corporate governance speeches outlining a proposal for an ideal board of directors on which the CEO would be the only member of management and would not serve as chairman.ⁿ⁴⁷ In the wake of the corporate scandals of 2001-2002, former SEC Chairman William Donaldson and other SEC commissioners spoke out on the important role of corporate directors in good corporate governance.ⁿ⁴⁸ Chairman Donaldson, for example, criticized the "Imperial CEO model of the 1990s" and advanced the need for greater responsibility and authority for directors.ⁿ⁴⁹ In several speeches in 2005 and 2006, SEC Commissioners and senior staff members talked about the important role of directors and other "gatekeepers."ⁿ⁵⁰ The swearing in of Chairman Mary Shapiro in 2009, combined with an unprecedented global financial crisis and the Madoff scandal, resulted in the SEC reenergizing its focus on enforcement. In this regard, Chairman Shapiro echoed former chairmen, asserting that "[i]t is precisely during times like these that we need the SEC as the 'investor's advocate.'"ⁿ⁵¹ In addition, Chairman Shapiro announced an ambitious rulemaking agenda that touches on a number of corporate governance issues, including proxy access for shareholders to nominate directors as well as enhanced disclosure with respect to board oversight, director qualifications, board leadership, compensation and risk management.ⁿ⁵² More recently, the SEC proposed proxy access rules and rules regarding enhanced disclosure in these areas.ⁿ⁵³

[3] Federal Law Enforcement

[a] Federal Sentencing Guidelines for Organizations

In the 1980s, Congress created the U.S. Sentencing Commission ("Sentencing Commission"),ⁿ⁵⁴ which subsequently issued guidelines for punishing business entities, including corporations, that have committed federal crimes.ⁿ⁵⁵ In enacting the Organizational Sentencing Guidelines, the Sentencing Commission codified compliance programs as the primary method by which corporations could mitigate potential criminal punishment after an indictment. Following the direction of Congress in the Sarbanes-Oxley Act,ⁿ⁵⁶ the Sentencing Commission reconsidered its guidelines and voted to strengthen the requirements for an effective compliance program.ⁿ⁵⁷ The revised guidelines are particularly relevant to corporate governance because, under the new standards for an effective compliance program, accountability must rest with the board of directors itself, which must assign a "high level" individual to oversee the company's compliance program.ⁿ⁵⁸

[b] Holder/Thompson/McNulty/Filip Memoranda

Effective compliance programs also are relevant to decisions by government agencies as to whether to prosecute corporations. In memoranda named after their respective signatories, the U.S. Department of Justice directed federal prosecutors to consider several factors in deciding whether to pursue criminal charges against a corporation.ⁿ⁵⁹ The more detailed Thompson memorandum directs prosecutors to place greater emphasis on compliance programs and stresses that management is "responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged."ⁿ⁶⁰ Moreover, as the Sentencing Guidelines emphasize, that responsibility ultimately rests with the board of directors. The Holder and Thompson memoranda were replaced by the McCulty memorandum in December 2006, and subsequently the Filip memorandum in August 2008, but neither changed the emphasis on a company's pre-existing compliance program as a factor to consider in determining whether to charge a corporation.ⁿ⁶¹ Rather, they address controversial aspects of the previous memoranda related to attorney-client privilege and company reimbursement of employee legal fees.

[4] Self-Regulatory Organizations

Other important contributors to corporate governance practices are the self-regulatory organizations--the securities exchanges and NASDAQ. Prior to the enactment of the federal securities laws in the 1930s, the stock exchanges, primarily the NYSE, had requirements for listing that had developed over the years.ⁿ⁶²

From time to time since enactment of the federal securities laws, the SEC has required the self-regulatory organizations to use their listing standards to improve the corporate governance of listed companies. The history of the self-regulatory organizations' requirements for audit committees is instructive in this regard.

As noted above, in 1939, after the SEC's investigation of McKesson and Robbins resulted in a recommendation that public companies have board audit committees, the NYSE endorsed the SEC's recommendation but stopped short of mandating audit committees.ⁿ⁶³ In the mid-1970s, after the revelations of questionable corporate payments had re-focused regulators' attention on the important role that well-functioning board audit committees can play,ⁿ⁶⁴ then-SEC Chairman Hills wrote a letter requesting the NYSE to review its listing standards with a view to requiring listed companies to have audit committees composed of outside directors. In 1977, the NYSE did so.ⁿ⁶⁵ The letter also addressed other corporate governance issues, including board composition and whether lawyers who advise companies should sit on their boards. The NYSE subsequently adopted a listing standard requiring listed companies to have audit committees whose members are independent of any relationship that would interfere with their exercise of independent judgment.ⁿ⁶⁶

In 1998, another SEC Chairman, Arthur Levitt, called upon the NYSE and NASD to further address audit committee

issues, which they did with the establishment in 1999 of a Blue Ribbon Committee on Improving the Effectiveness of Audit Committees.ⁿ⁶⁷ That committee issued recommendations, which were subsequently implemented by SEC, NYSE and NASD rules.ⁿ⁶⁸ SEC Chairman Levitt later stated that "the blue ribbon committee did more to change the culture of corporate governance than almost anything we did at the SEC."ⁿ⁶⁹

In December 2002, in the wake of the revelations of accounting and other corporate frauds in 2001-2002, then-SEC Chairman Harvey Pitt asked the NYSE and NASD to review their listing standards and consider additional corporate governance measures. They subsequently proposed and adopted far-reaching changes in their listing standards governing the composition and functioning of their listed companies' boards of directors (including changes mandated by the Sarbanes-Oxley Act, whose passage overtook the self-regulatory organizations' efforts already underway in this area).ⁿ⁷⁰ Independent directors, under tightened definitions of independence,ⁿ⁷¹ must now constitute a majority of the board of directors of listed companies,ⁿ⁷² and such boards must have audit, compensation and nominating/corporate governance committeesⁿ⁷³ (or committees performing the same functions under other namesⁿ⁷⁴ or, in the case of NASDAQ companies, independent directors performing the functions of the compensation and nominating committeesⁿ⁷⁵).

These 2003 corporate governance listing standards gave the self-regulatory organizations a much greater role in the corporate governance of their listed companies than they had in the past. In this regard, the self-regulatory organizations are being called upon to interpret their corporate governance listing requirements in ways that involve them in questions of board deliberations and operations.ⁿ⁷⁶ Moreover, the NYSE requires annual affirmations and certifications from its listed companies with respect to compliance with the corporate governance listing standardsⁿ⁷⁷ and both the NYSE and NASDAQ require notification if a company's executive officer becomes aware of any material non-compliance with the listing standards.ⁿ⁷⁸

The NYSE also prescribes rules governing the ability of brokers to vote the securities of their customers whose securities are held in "street name"--*i.e.* in the name of the broker-dealer. Under these rules, brokers who are members of the NYSE have "discretionary" authority to vote such shares if the subject matter is deemed "routine" by the NYSE and the broker has not received voting instructions from the beneficial owner by the tenth day before the meeting date.ⁿ⁷⁹ Historically, the election of directors was considered a "routine" matter in the absence of a proxy contest. Institutional investors have expressed concern about this, because brokers generally supported the company's candidates. In April 2007, the NYSE formed a Proxy Working Group to examine this issue and in June 2006, the Group recommended that all director elections be "non-routine" so that brokers would not be able to vote on a discretionary basis with respect to uncontested director elections. In October 2006, the NYSE filed with the SEC a proposed amendment of NYSE Rule 452ⁿ⁸⁰ that would have implemented this recommendation for shareholder meetings held on or after

January 1, 2008.ⁿ⁸¹ On February 26, 2009, the NYSE filed an updated proposal to amend Rule 452 with the SEC.ⁿ⁸² The SEC subsequently approved the proposed changes to NYSE Rule 452, thus eliminating broker discretionary voting in uncontested director elections beginning at shareholder meetings held after January 1, 2010.ⁿ⁸³

[5] Best Practices

Because corporate governance is much more than a matter of law, many of the sources of guidance on corporate governance practices are not captured in rules and regulations but, rather, are set forth in statements, principles and white papers issued by bar associations, institutional investors, business groups and proxy voting advisory services, among others. These have come to be collectively referred to as recommended "best practices." While companies are not required to follow these so-called best practices, they may be penalized by their shareholders or potential investors if they fail to do so.

[a] American Law Institute

In 1982, the American Law Institute ("ALI"), an organization of legal professionals that creates restatements and model codes and undertakes other projects intended to clarify or spur reform in various areas of the law, published the first draft of its "Principles of Corporate Governance: Analysis and Recommendations" ("ALI Principles of Corporate Governance"). The ALI published the ALI Principles of Corporate Governance in 1994, after 12 years of debate and revision. A basic purpose of the project was to clarify the duties and obligations of corporate directors and officers and to provide guidelines for discharging those responsibilities in an efficient manner, with minimum risks of personal liability.ⁿ⁸⁴ In contrast to many other ALI publications, the ALI Principles of Corporate Governance is not a restatement of the law, as some of its material is in the nature of recommendations. Nevertheless, courts and practitioners have looked to the ALI Principles of Corporate Governance for guidance on the structure, functions, and powers of corporate boards, and the duties of officers and directors.ⁿ⁸⁵

[b] American Bar Association

The Committee on Corporate Laws of the American Bar Association ("ABA") has long played a role in the development of corporation law in the United States. It developed the Model Business Corporation Act ("Model Act"), first issued in 1950, which has been adopted substantially in its entirety in more than 30 states.ⁿ⁸⁶ Moreover, since 1978, it has issued five editions of the "Corporate Director's Guidebook" to provide guidance to corporate directors in meeting their responsibilities. The fifth edition, published in 2007, focuses on the "increasingly vital role that directors play in protecting investors' interests and in directing and overseeing corporate strategy and its execution by senior officers."ⁿ⁸⁷ Designed to be read by directors, it lays out the duties, responsibilities, and rights of a corporate director, sets forth guidance on operations and effective board and committee structures and suggests other oversight activities for the board of directors. It provides specific guidance on such issues as board leadership, size, meetings, quality of information and time commitment.

In the wake of the corporate failures in 2001-2002, the ABA appointed a Task Force on Corporate Responsibility to "examine systematic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-related situations that have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States."ⁿ⁸⁸ In March 2003, the Task Force issued a report recommending reforms relating to the composition, conduct and responsibilities of public company boards of directors and their committees and the professional conduct of lawyers.ⁿ⁸⁹ The recommendations are similar to those of other groups concerning the composition and structure of the board and board committees, but they go further than previous best practice documents in some respects. For example, they call for the general counsel and independent directors to meet more frequently (without other members of management).ⁿ⁹⁰ The report of the ABA Task Force also called for boards to consider policies relating to the setting of agendas and distribution of information, time commitments of directors, rotation of the chair, membership of committees, and the appointment of a lead director.ⁿ⁹¹ The report took the position that lawyers have a professional responsibility to disclose information, sometimes even to third parties, concerning criminal or fraudulent conduct of their corporate clients. The ABA Task Force recommendations were adopted as ABA policy by vote of the ABA House of Delegates in August 2003.ⁿ⁹²

In April 2005, the American Bar Association Committee on Corporate Law created a Task Force on Director Elections to address issues relating to shareholder voting in uncontested elections at public companies and to consider whether to recommend changes to the Model Act. After several solicitations of comments, in 2006, the Task Force recommended changes in the Model Act that provide corporations greater flexibility in their director election process, including modification of the "holdover" director rule and a "modified plurality approach." These changes to the Model Act were adopted in 2006. Subsequently, at least eleven states have amended their corporation statutes to facilitate the adoption of a majority voting for the election of directors.ⁿ⁹³ For further discussion of this approach, *see* § 6.02[6] *below*.

The Committee on Corporate Laws also has addressed the issue of proxy access. On June 29, 2009, the Committee approved proposed amendments to the Model Act that expressly permit shareholder access to corporate proxy materials to nominate directors as well as permit the reimbursement of shareholders soliciting proxies for the election of

directors.ⁿ⁹⁴ In August 2009, the Committee published these proposed amendments for public comment. Following the comment period, the committee is expected to consider the proposed amendments for adoption.

[c] Business Roundtable

The Business Roundtable, an association of chief executive officers of leading U.S. corporations, has long been active in corporate governance matters. In 1978, it published "The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation," which it updated in 1997 with its "Statement on Corporate Governance," and again in May 2002 with its "Principles of Corporate Governance" ("Business Roundtable Principles").ⁿ⁹⁵ The Business Roundtable Principles were issued in the midst of the revelations of corporate misconduct in 2001-2002--after Enron, but before WorldCom. They call on companies to: (1) ensure that a substantial majority of the board of directors comprises directors who are independent both in fact and in appearance; (2) require that only independent directors sit on the board committees that oversee the three functions central to effective corporate governance--audit, corporate governance and compensation; and (3) create and publish corporate governance principles so that everyone, from employees to potential investors, understands the governance rules under which the company operates; among other recommendations. The Business Roundtable Principles were issued shortly before the NYSE Corporate Accountability and Listing Standards Committee issued its recommendations for corporate governance enhancements to the NYSE listing standards in June 2002.ⁿ⁹⁶ These recommendations, with minor changes, formed the basis for the corporate governance listing standards that the NYSE filed with the SEC in August 2002, which were ultimately approved by the SEC in November 2003.ⁿ⁹⁷ Subsequently, in November 2005, the Business Roundtable updated its Principles to reflect the enactment of the Sarbanes-Oxley Act, the adoption of the securities markets corporate governance listing standards and further developments in corporate governance best practices.

The Business Roundtable also has issued several other corporate governance best practices documents. In November 2003, it issued "Executive Compensation: Principles and Commentary," which calls for the executive compensation program of every publicly held company to adhere to two fundamental characteristics: pay for performance and oversight by a compensation committee composed solely of independent directors.ⁿ⁹⁸ These Principles were updated in January 2007.ⁿ⁹⁹ In April 2004, the Business Roundtable issued "The Nominating Process and Corporate Governance Committees: Principles and Commentary," setting forth seven best practices for the nominating process and corporate governance committees,ⁿ¹⁰⁰ and, in May 2005, the Business Roundtable issued "Guidelines for Shareholder-Director Communications."ⁿ¹⁰¹

[d] Institutional Investors

As discussed above, corporate governance issues, particularly the composition, structure and practices of boards of directors, have been of interest to institutional investors at least since the 1970s.ⁿ¹⁰² Several institutional investors and groups of such investors have issued their own corporate governance guidelines expressing their expectations about how boards of directors should operate.ⁿ¹⁰³ Institutions often use these guidelines in making voting decisions with respect to the election of directors and other matters at companies' annual meetings.ⁿ¹⁰⁴ Institutions also take policy positions through organizations such as the Council of Institutional Investors ("CII")ⁿ¹⁰⁵ and the International Corporate Governance Network.ⁿ¹⁰⁶ For example, in Spring 2005, CII sent letters to 1500 U.S. companies urging them to adopt a majority voting requirement for director elections. And, in October 2006, a group of 13 institutional investors sent a joint letter to the 25 largest companies in the Standard & Poor's 500-stock index seeking information on the any business ties that the compensation consultant used by their Compensation Committee has with the company.ⁿ¹⁰⁷

Many institutional investors rely on proxy voting advisory services, such as RiskMetrics Group, Inc. ("RiskMetrics") (which acquired Institutional Shareholder Services, Inc. in January 2007), Glass Lewis & Co., and Proxy Governance Inc. to make voting recommendations or actually vote the institution's shares in connection with the election of directors and other matters at companies' annual and special meetings.ⁿ¹⁰⁸ RiskMetrics has adopted positions on various corporate governance matters and bases its voting recommendations on these positions.ⁿ¹⁰⁹ For example, RiskMetrics

has adopted a tighter definition of director independence than that of the self-regulatory organizations¹¹⁰ and recommends that its clients withhold authority from, or vote against, directors who do not meet the RiskMetrics definition of independence and serve on the audit, nominating or compensation committees. Accordingly, companies increasingly consider RiskMetrics and Glass Lewis positions in addressing corporate governance issues.

[e] Post-Enron Scandal Reports

The reports issued by Congressional committees,¹¹¹ bankruptcy examiners,¹¹² corporate monitors¹¹³ and private sector groups¹¹⁴ in the wake of the corporate scandals in 2001-2002 recite a litany of failures on the part of boards of directors and set forth a panoply of recommendations for corporate governance changes. The Report of the Senate Permanent Committee on Investigations on Enron, for example, pointed to "a dozen red flags that should have caused the Enron Board to ask hard questions, examine Enron policies, and consider changing course."¹¹⁵ Further, it stated that "the Enron Board failed to provide the prudent oversight and checks and balances that its fiduciary obligations required and a company like Enron needed."¹¹⁶ The Thornburgh Report on WorldCom observed that the company's management provided "the Directors with extremely limited information regarding many acquisition transactions," that there was "virtually no meaningful Board oversight" of the company's debt obligations and that "the Compensation Committee failed to perform appropriate due diligence."¹¹⁷

The report issued by Richard Breeden, former Chairman of the SEC and corporate monitor of WorldCom/MCI, goes well beyond criticism of board behavior and calls itself a "blueprint for action."¹¹⁸ It contains 78 specific corporate governance recommendations.¹¹⁹ Significantly, many of these recommendations were included in MCI's articles of incorporation when it emerged from bankruptcy and can only be changed with the approval of MCI's board and shareholders.¹²⁰ Among the more unusual recommendations: (1) independent MCI directors should serve on no more than two other boards;¹²¹ (2) each director should be required to possess at least one of seven listed skills;¹²² (3) all executive compensation must be linked to "serious corporate performance measures";¹²³ (4) the governance committee should maintain a website that offers stockholders a "town meeting" forum, (5) shareholders owning at least 1 percent of MCI's voting power should be able to place resolutions on the website for consideration by all stockholders.¹²⁴

Other private sector groups also have issued reports recommending changes in corporate governance practices. For example, the Conference Board has issued reports on corporate governance issues over the years.¹²⁵ In 2002, that organization established a Commission on Public Trust and Private Enterprise, which issued a three-part report dealing with executive compensation, accounting and corporate governance issues.¹²⁶ In addition, the National Association of Corporate Directors ("NACD") has established several "Blue Ribbon" commissions on corporate governance issues that have issued "best practices" reports.¹²⁷

[f] Post-Financial Crisis Reports

In response to the global financial crisis of 2008-2009, several organizations issued reports and other publications related to corporate governance issues. For example, in 2009, the Conference Board issued a series of reports providing guidance to boards of directors in times of crisis.¹²⁸ Also in 2009, NACD and the Business Roundtable published a list of key agreed governance principles intended to provide a blueprint for strengthening corporate governance. The agreed principles highlight several key concepts, such as the importance of transparency and accountability in corporate governance, while stressing the notion that there is no "one size fits all" approach to corporate governance.¹²⁹

The global financial crisis also may bring about a pronounced shift in the role the federal government with respect to corporate governance. Pending legislation would bring traditional state law issues, such as board classification and majority voting, within the sphere of federal regulation. Similarly, such legislation would empower the SEC to regulate areas traditionally governed by state law. Thus, it is expected that federal law will become increasingly important as a source of corporate governance law.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Governing Documents & Procedures General Overview Criminal Law & Procedure Sentencing Guidelines General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act Securities Law Initial Public Offerings & the Securities Act of 1933 General Overview Securities Law Investment Companies General Overview Securities Law Self-Regulating Entities General Overview Securities Law U.S. Securities & Exchange Commission Rulemaking Securities Law U.S. Securities & Exchange Commission Special Powers

FOOTNOTES:

(n1)Footnote 1. *See §§ 4.01-4.03 below* .

(n2)Footnote 2. *See, e.g., Del. Code Ann. tit. 8, §§ 211-214 (2003).*

(n3)Footnote 3. *See, e.g., Del. Code Ann. tit. 8, §§ 251-264 (2003).*

(n4)Footnote 4. *See § 4.03[5] below* for a more detailed discussion of the business judgment rule.

(n5)Footnote 5. On June 15, 2005, the Council of Institutional Investors sent a letter to the Chairman of the Corporation Law Section of the Delaware State Bar Association urging that the Section consider recommending that the Delaware legislature amend Section 216 of the Delaware General Corporation Law "to make majority voting for director elections the presumptive choice for Delaware corporations." While the Delaware legislature retained the plurality voting standard default for director elections, in 2006, it amended the Delaware General Corporation Law: (1) to provide that shareholder bylaws specifying the vote required for the election of directors may only be amended by the shareholders; and (2) to permit a director resignation conditioned on the director not receiving a specified vote for reelection. 2006 amendments to Sections 216 and 141(b) of the Delaware General Corporation Law.

(n6)Footnote 6. *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) ; *In re Walt Disney Co. Derivative Litig.*, 2005 Del. Ch. LEXIS 113 (unpublished) (Aug. 9, 2005) .

(n7)Footnote 7. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) , *aff'd*, 872 A.2d 960 (Del. 2005) .

(n8)Footnote 8. *Official Comm. of Unsecured Creditors of Integrated Health Servs. v. Elkins*, 2004 Del. Ch. LEXIS 122 (Aug. 24, 2004) .

(n9)Footnote 9. States that have amended their corporation statutes to allow majority voting include California, Delaware, Georgia, Nevada, New Jersey, New York, North Dakota, Ohio, Utah, Virginia and Washington.

(n10)Footnote 10. *See* Transcript of SEC Roundtable on the Federal Proxy Rules and State Corporation Law, May 7, 2007; Transcript of SEC Roundtable on the Federal Proxy Rules and State Corporation Law, May 25, 2007.

(n11)Footnote 11. *See* Shareholder Proposals, SEC Release No. 34-56160 (July 27, 2007); Shareholder Proposals Relating to the Election of Directors, SEC Release No. 34-56161 (July 27, 2007).

(n12)Footnote 12. *See* Shareholder Proposals Relating to the Election of Directors (December 6, 2007).

(n13)Footnote 13. In October 2009, HealthSouth Corporation became the first major U.S. corporation to respond to this change in Delaware law when its board of directors approved a bylaw amendment providing for reimbursement of shareholder expenses in connection with a proxy solicitation campaign. *See* Press Release, HeathSouth Corporation,

"HealthSouth Commits to a Reimbursement Policy for Shareholder Proxy Nominations" (Oct. 26, 2009).

(n14)Footnote 14. For comprehensive analysis of the securities laws, *see generally* A.A. Sommer, Jr. (Gen. Ed.) *Federal Securities Act of 1933*; A.A. Sommer, Jr. (Gen. Ed. Matthew Bender & Co., Inc., 2008), *Federal Securities Exchange Act of 1934*. For practice-oriented analysis and guidance on both transactional and litigation/enforcement issues, *see generally* A.A. Sommer, Jr. (Gen. Ed., Matthew Bender & Co., Inc., 2008), *Securities Law Techniques*.

(n15)Footnote 15. 1934 Act § 14(a), *15 U.S.C. § 78n(a)*.

(n16)Footnote 16. *See* John C. Coffee, Jr., *Corporate Securities; Federalism and the SEC's Proxy Proposals*, N.Y.L.J., Mar. 18, 2003, at 5. *But see* Roberta S. Karmel, *Shareholder Nominations: Increased Access to Proxy Card?*, N.Y.L.J., Dec. 18, 2003, at 3.

(n17)Footnote 17. *Business Roundtable v. SEC*, 905 F.2d 406, 284 U.S. App. D.C. 301 (D.C. Cir. 1990) .

(n18)Footnote 18. *Business Roundtable*, 905 F.2d at 411 .

(n19)Footnote 19. For a discussion of this rulemaking, *see* § 8.03[1][d] below. *See also* Andrew R. Brownstein & Igor Kirman, *Shareholder Access Proposals Conflict with Federal Proxy Rules and State Law*, M&A Lawyer, Feb. 2003, at 1.

(n20)Footnote 20. Sarbanes-Oxley Act § 402, *15 U.S.C. § 78m(k)*.

(n21)Footnote 21. Sarbanes-Oxley Act § 302, *15 U.S.C § 7241*; § 906, *18 U.S.C. § 1350*.

(n22)Footnote 22. Sarbanes-Oxley Act § 404, *15 U.S.C. § 7262*.

(n23)Footnote 23. Sarbanes-Oxley Act § 301, *15 U.S.C. § 78j-1(m)*; § 407, *15 U.S.C. § 7265*.

(n24)Footnote 24. *See, e.g.*, Regulation S-K Item 401, *17 CFR § 229.401*.

(n25)Footnote 25. *See* § 1.02[3] above.

(n26)Footnote 26. SEC Release No. 34-15384 (Dec. 6, 1978). The nominating, audit and compensation committees, respectively, are discussed in detail in Chapters 8, 9 and 10 below.

(n27)Footnote 27. Schedule 14A Item 7, *17 CFR § 240.14a-101*.

(n28)Footnote 28. SEC Release No. 34-4970 (July 18, 1980).

(n29)Footnote 29. The independence requirements for members of each of the nominating, audit and compensation committees, respectively, are discussed in §§ 8.02, 9.03 and 10.05[1] below .

(n30)Footnote 30. Release No. 33-8732 (August 11, 2006).

(n31)Footnote 31. 1934 Act Rule 16b-3, *17 CFR § 240.16b-3*. *See* § 10.05[1][b] below for further discussion of 1934 Act Rule 16b-3 requirements.

(n32)Footnote 32. *See* *17 CFR § 240.14a-101* Item 8; *17 CFR § 229.402(k)*.

(n33)Footnote 33. SEC Release No. 34-48825 (Nov. 28, 2003). *See* § 8.03[1][a][i] below for more discussion of these rules.

(n34)Footnote 34. *See, e.g.*, 1934 Act Rule 13a-15, *17 CFR § 240.13a-5*.

(n35)Footnote 35. *See* Sarbanes-Oxley Act § 407, 15 U.S.C. § 7265; Regulation S-K Item 401(h), 17 CFR § 229.401(h) requiring disclosure of whether a company has one or more "audit committee financial experts" on its audit committee.

(n36)Footnote 36. *See* Sarbanes-Oxley § 307, 15 U.S.C. § 7245; 17 CFR § 205.2(o).

(n37)Footnote 37. *See* Sarbanes-Oxley Act § 101, 15 U.S.C. § 7211; PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements (effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02, July 27, 2007); PCAOB Rule 3522, Tax Transactions (effective pursuant to SEC Release No. 34-3677; File No. PCAOB-2006-01, April 19, 2006); PCAOB Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles (effective pursuant to SEC Release No. 34-3677; File No. PCAOB-2006-01, April 19, 2006).

(n38)Footnote 38. Similarly, Congressional committees have issued reports of investigations in connection with the corporate scandals of 2001-2002. *See, e.g.*, "The Role of the Board of Directors in Enron's Collapse," Senate Permanent Subcommittee on Investigations of the Senate Comm. on Investigations, S. Prt. 107-70 (July 8, 2002).

(n39)Footnote 39. SEC Accounting Series Release No. 19 (Dec. 5, 1990). The New York Stock Exchange ("NYSE") also advocated the establishment of audit committees composed of non-affiliated directors in 1939. Report of the Subcommittee on Independent Audit and Procedure of the NYSE Committee on Stock List 7 (1939).

(n40)Footnote 40. The Financial Collapse of the Penn Central Company, Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, Committee on Interstate and Foreign Commerce, U.S. House of Representatives (1972).

(n41)Footnote 41. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., SEC Release No. 34-39157 (Sept. 30, 1997).

(n42)Footnote 42. *See* SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal. 1974); *see also* SEC v. Killearn Props., Inc., Civ. Action No. TCA-7567, 1977 U.S. Dist. LEXIS 16073 (N.D. Fla. May 2, 1977); SEC v. Allegheny Beverage Corp., Civ. Action No. 932-73, 1973 U.S. Dist. LEXIS 11898 (D.D.C. Sept. 14, 1973).

(n43)Footnote 43. *See* SEC v. Potter Instrument Co., Civ. Action No. 77-0394, 1977 U.S. Dist. LEXIS 16981 (D.D.C. Mar. 9, 1977), 1977 U.S. Dist. LEXIS 15967 (D.D.C. May 9, 1977), SEC Release No. 34-7910 (May 10, 1977).

(n44)Footnote 44. SEC Litigation Release No. 2065 (July 28, 2004). Similarly, in settling private litigation, shareholders are insisting upon corporate governance changes. For example, Broadcom agreed to give shareholders the ability to nominate candidates for one seat on the board of directors. Broadcom, Form 8-K (June 14, 2004), and Applied Micro Circuit agreed to appoint two different people to be CEO and chairman of the Board.

(n45)Footnote 45. Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Release No. 34-44969 (Oct. 23, 2001).

(n46)Footnote 46. Testimony of Roderick Hills, "Corporate Rights and Responsibilities" Hearings, Sen. Commerce Comm. 94th Cong., 2nd less (1976) pp. 301-308.

(n47)Footnote 47. *See, e.g.*, Address of Harold Williams, Jan. 18, 1978.

(n48)Footnote 48. SEC Chairman William Donaldson, Remarks from Director's College, Stanford University Law School (June 20, 2004); Commissioner Cynthia Glassman, Board Independence and the Evolving Role of Directors,

Address delivered at the 26th Annual Conference on Securities Regulations and Business Law Problems (Feb. 20, 2004).

(n49)Footnote 49. *See* SEC Chairman William Donaldson, Remarks from Director's College, Stanford University Law School (June 20, 2004).

(n50)Footnote 50. Commissioner Roel Campos, "How to Be an Effective Board Member," Aug. 15, 2006; Brian Cartwright "Remarks before the 2006 Investment Company Directors Conference," Nov. 15, 2006; Brian Cartwright, "Remarks in Honor of the Establishment of the Arthur and Toni Rock Center for Corporate Governance at Stanford University" May 13, 2006; Linda Thomsen, "Covering the Bases" (June 21, 2005).

(n51)Footnote 51. *See* Chairman Mary L. Shapiro, Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009).

(n52)Footnote 52. *See* Chairman Mary L. Shapiro, Speech by SEC Chairman: Address to the Council of Institutional Investors (April 6, 2009).

(n53)Footnote 53. SEC Release No. 33-9046 (Jun. 10, 2009); SEC Release No. 33-9052 (Jul. 10, 2009).

(n54)Footnote 54. *See* Ch. II of the Comprehensive Crime Control Act of 1984, Pub. L. No. 98-473 (Oct. 12, 1984).

(n55)Footnote 55. *See* An Overview of the United States Sentencing Commission and the Organizational Guidelines, at 1, *available at* www.usc.gov/training/corcover.pdf. The U.S. Supreme Court's June 24, 2004 decision in *Blakely v. Washington*, 542 U.S. 296, 124 S. Ct. 2531, 159 L. Ed. 2d 403 (2004), places the constitutionality of the sentencing guidelines in doubt but, in any event, the provisions related to compliance programs are likely to remain in effect by Congressional actions or otherwise.

(n56)Footnote 56. *See* Sarbanes-Oxley Act § 805.

(n57)Footnote 57. The amended organizational sentencing guidelines, which were delivered to Congress April 30, 2004 and became effective November 1, 2004, are reproduced in Appendix 13-A to Chapter 13 *below*.

(n58)Footnote 58. *See* § 13.02 *below* for further discussion of the board of directors' responsibilities with respect to compliance programs.

(n59)Footnote 59. Office of the Deputy Attorney General, Bringing Criminal Charges Against Corporations (attaching the document "Federal Prosecution of Business Organizations") (the "Holder Memo"); Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (attaching revisions to the Holder memo) (the "Thompson Memo"); Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (attaching the document "Principles of Federal Prosecution of Business Organizations") (the McCulty Memo); Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (attaching the document "Principles of Federal Prosecution of Business Organizations") (the "Filip Memo") all *available at* www.usdoj.gov.

(n60)Footnote 60. Thompson memo at IV.B. The Thompson Memo is reproduced in Appendix 13-B to Chapter 13 *below*.

(n61)Footnote 61. *Id.*

(n62)Footnote 62. For further discussion of the evolution of exchange listing requirements, *see* L. Loss, *Securities Regulation* 804 (1961 ed.).

(n63)Footnote 63. Report of the Subcommittee on Independent Audits and Procedure of NYSE Committee on Stock List 7 (1939).

(n64)Footnote 64. *See* SEC, Report on Questionable and Illegal Corporate Payments and Practices, Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2nd Sess. (Comm. Print 1976) at 67-69.

(n65)Footnote 65. *See* Letter from then-SEC Chairman Roderick Hills to then-NYSE Chairman William Batten (1977).

(n66)Footnote 66. Joel Seligman, *The Transformation of Wall Street* 547 (3d ed. 2003).

(n67)Footnote 67. Joel Seligman, *The Transformation of Wall Street* 720 (3d ed. 2003).

(n68)Footnote 68. 71 SEC Docket 624, 639, and 787 (1999).

(n69)Footnote 69. Arthur Levitt, *Take on the Street* 222 (2002).

(n70)Footnote 70. *See* §§ 6.02, 8.02, 9.02, 10.04, *below* for further discussion of these listing standards.

(n71)Footnote 71. NYSE Listed Company Manual § 303A.02; NASDAQ Rule 5605(a)(2). The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise. NASDAQ Rule 5605(a)(2) and the related interpretation, IM-5605, are reproduced in Appendix C to this treatise.

(n72)Footnote 72. NYSE Listed Company Manual § 303A.01; NASDAQ Rule 5605(b). NASDAQ Rule 5605(b) and the related interpretation, IM-5605-1, are reproduced in Appendix C to this treatise.

(n73)Footnote 73. NYSE Listed Company Manual §§ 303A.04(a), 303A.05(a) and 303A.06; NASDAQ Rule 5605(c), (b) and (e).

(n74)Footnote 74. NYSE Listed Company Manual § 303A.04 Commentary.

(n75)Footnote 75. NASDAQ Rule 5605(d) and (e).

(n76)Footnote 76. *See* NYSE, NYSE Listed Company Manual § 303A, Corporate Governance Listing Standards, Frequently Asked Questions (Feb. 13, 2004), *available at* www.nyse.com/pdfs/section303Afaqs.pdf.

(n77)Footnote 77. NYSE Listed Company Manual § 303A.12(a).

(n78)Footnote 78. NYSE Listed Company Manual § 303A.12(b); NASD Rule 4350(m).

(n79)Footnote 79. *See* NYSE Rules 450 and 452.

(n80)Footnote 80. The NYSE also filed a corresponding proposed amendment to NYSE Listed Company Manual Section 402.08.

(n81)Footnote 81. SEC File No. SR-NYSE-2006-92. Subsequently, acting upon the recommendation of the Proxy Voting Group, the NYSE filed an amendment to its proposal such that the amendment of Rule 452 would not apply to any registered investment company. SEC File No. SR-2006-92 Amendment No. 1.

(n82)Footnote 82. SEC File No. SR-2006-92 Amendment No. 4.

(n83)Footnote 83. SEC Release No. 34-60215 (Jul. 1, 2009).

(n84)Footnote 84. For a discussion of the history of the ALI's Corporate Governance Project, *see* President's

Forward, ALI, *Principles of Corporate Governance: Analysis and Recommendations XI* (1994).

(n85)Footnote 85. *See, e.g., Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004) (citing ALI test for who may bring a direct action); *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) (comparing Delaware and ALI standards for what directors are expected to know when making decisions).

(n86)Footnote 86. *See* ABA Committee on Corporate Laws, *Corporate Director's Guidebook* (5th ed. 2007) [hereinafter ABA Corporate Director's Guidebook].

(n87)Footnote 87. ABA Corporate Director's Guidebook vii.

(n88)Footnote 88. Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003), *available at* www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, 59 *Bus. Law.* 145 (2003) [hereinafter ABA Task Force Corporate Responsibility Report].

(n89)Footnote 89. *See* ABA Task Force Corporate Responsibility Report; *see also* § 14.07 below for further discussion of the role of lawyers in corporate governance.

(n90)Footnote 90. ABA Task Force Corporate Responsibility Report, Recommendation No. 8.

(n91)Footnote 91. ABA Task Force Corporate Responsibility Report, Recommendation No. 10.

(n92)Footnote 92. *See* www.abanet.org/leadership/2003/journal/119c.pdf.

(n93)Footnote 93. California, Delaware, Georgia, Nevada, New Jersey, New York, North Dakota, Ohio, Utah, Virginia and Washington.

(n94)Footnote 94. *See* Press Release, American Bar Association Section of Business Law, "Corporate Laws Committee Takes Steps to Provide for Shareholder Access to the Nomination Process" (Jun. 29, 2009).

(n95)Footnote 95. The Business Roundtable Principles are reproduced in Appendix A to this treatise.

(n96)Footnote 96. Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee (CALs) (June 6, 2002).

(n97)Footnote 97. *See* SEC Release No. 34-48745 (Nov. 4, 2003).

(n98)Footnote 98. This Business Roundtable report is reproduced in Appendix 15-A to Chapter 15 *below*.

(n99)Footnote 99. *Available at* <http://www.businessroundtable.org/sites/default/files/ExecutiveCompensationPrinciples.pdf>.

(n100)Footnote 100. This Business Roundtable report is reproduced in Appendix 8-B to Chapter 8 *below*.

(n101)Footnote 101. *Available at* <http://www.businessroundtable.org/sites/default/files/20050527003ShareholderCommunicationsGuidelines-FINAL-5.26.05.pdf>.

(n102)Footnote 102. *See* § 1.02[4] *above*.

(n103)Footnote 103. *See, e.g.,* CalPERS, *Global Principles of Accountable Corporate Governance* (Mar. 2009); TIAA-CREF, *Policy Statement on Corporate Governance* (Oct. 1997, revised Jan. 2004 and March 2007); Council of Institutional Investors, *Corporate Governance Policies* (Mar. 1998, last updated May 2009); American Federation of Labor and Congress of Industrial Organizations, *Investing in Our Future: AFL-CIO Proxy Voting Guidelines* (1997).

(n104)Footnote 104. *See* § 2.01[4] below.

(n105)Footnote 105. *See* <http://www.cii.org>.

(n106)Footnote 106. *See* <http://www.icgn.org>.

(n107)Footnote 107. *See* "GE Accedes to More Disclosure on Pay Advice," Wall Street Journal, December 29, 2006, at A2.

(n108)Footnote 108. This reliance has come under significant criticism. *See* Report of the NYSE Proxy Working Group, June 2006.

(n109)Footnote 109. These positions are set forth in the ISS U.S. Proxy Voting Manual.

(n110)Footnote 110. *See* § 8.03[1][a][ii] below.

(n111)Footnote 111. The Role of the Board of Directors in Enron's Collapse, Report prepared by the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs (July 8, 2002) [hereinafter Senate Enron Report].

(n112)Footnote 112. Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re: WorldCom, Inc., et al., Debtors*, Case No. 02-15533, U.S. Bankruptcy Court S.D.N.Y. (June 9, 2003) [hereinafter Thornburgh Report].

(n113)Footnote 113. Richard Breeden, Restoring Trust: Corporate Governance For The Future of MCI, Inc., Report to Hon. Jed S. Rakoff, S.D.N.Y. (Aug. 2003) [hereinafter Breeden Report].

(n114)Footnote 114. *See, e.g.*, The Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations, Part 1: Executive Compensation (Sept. 2002), and Part 2: Corporate Governance and Part 3: Auditing And Accounting (Jan. 2003), available at www.conference-board.org/pdf_free/758.pdf.

(n115)Footnote 115. Senate Enron Report 60.

(n116)Footnote 116. Senate Enron Report 60.

(n117)Footnote 117. Thornburgh Report 7, 9, 10.

(n118)Footnote 118. Breeden Report 1.

(n119)Footnote 119. Some commentators have suggested that the Breeden Report is a "kitchen sink" of corporate governance recommendations. *See, e.g.*, *MCI Reforms: Should Others Follow?*, Legal Times, Apr. 5, 2004, at 23 (reporting comment of Martin Lipton, founding partner of Wachtell, Lipton, Rosen & Katz, on the Breeden Report: "This report is a compendium of just about every corporate governance suggestion that has ever been made, with the rejection of virtually none of the prior suggestions."); Amalia Deligiannis, *Worldcom's Governance Expert Cleans House, Corp.* Legal Times, Nov. 2003, at 26 (characterizing recommendations in Breeden Report as "more than most companies would want or should be doing on the governance front").

(n120)Footnote 120. *See* Breeden Report.

(n121)Footnote 121. Breeden Report, Recommendation No. 1.12.

(n122)Footnote 122. Breeden Report, Recommendation 1.09.

(n123)Footnote 123. Breeden Report, Recommendation 4.01.

(n124)Footnote 124. Breeden Report, Recommendation 6.04.

(n125)Footnote 125. *See, e.g.*, The Conference Board, *Corporate Boards: Improving and Evaluating Performance* (1994).

(n126)Footnote 126. The Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations, Part 1: Executive Compensation (Sept. 2002), and Part 2: Corporate Governance and Part 3: Auditing and Accounting (Jan. 2003), *available at* www.conference-board.org/pdf_free/758.pdf.

(n127)Footnote 127. *See, e.g.*, NACD, Report of The Blue Ribbon Commission on Director Professionalism (1996, reissued 2001); NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee (2003), discussed in § 15.06[2] *below* (excerpts from this NACD report are reproduced in Appendices 16-B and 16-C to Chapter 16 *below*); NACD, Report of the NACD Blue Ribbon Commission on Audit Committees: A Practical Guide (updated 2004 ed.); Report of the NACD Blue Ribbon Commission on Board Leadership (2004); NACD, Report of the NACD Blue Ribbon Commission on CEO Succession; NACD, Report of the NACD Blue Ribbon Commission on Risk Oversight: Board Lessons for Turbulent Times; NACD, Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy; Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness (2005); NACD Report of the NACD Blue Ribbon Commission on Director Liability: Myths, Realities and Prevention (2006); Report of the NACD Blue Ribbon Commission on Director Compensation: Purpose, Principles and Best Practices (2006).

(n128)Footnote 128. The Conference Board, *The Role of the Board in Turbulent Times: Avoiding Shareholder Activism* (Apr. 2009); The Conference Board, *The Role of the Board in Turbulent Times: Overseeing Internal Investigations* (Feb. 2009).

(n129)Footnote 129. NACD, *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies* (2009).



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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice 2.syn

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§ 2.syn Synopsis to Chapter 2: THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

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(n1)Footnote *. The authors would like to acknowledge the contributions of Elizabeth A. Ising, Susan M. Reilly and R. McMillan Price associates at Gibson, Dunn & Crutcher LLP in Washington, D.C.



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Corporate Governance: Law and Practice

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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.01

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§ 2.01 Aspects of the Market Response to Corporate Scandals and the Financial Crisis

The well-publicized corporate scandals at the turn of the last century strained the trust between investors and companies. In some cases, causing drops in equity valuations and provoked multiple responses from financial regulators and policy-makers. Investors began to consider corporate governance as a factor in investment decisions,ⁿ¹ spurring market demand for information about the quality of corporate governance on a company-by-company level. This increasing investor focus on governance resulted in the development of published rating metrics or systems that evaluate, rank and compare the corporate governance practices of public companies.ⁿ² Moreover, the belief that corporate governance failures were at least partly responsible for the financial crisis that began in 2008 has led to renewed scrutiny of corporate governance practices.ⁿ³

[1] Emergence of Corporate Governance Rating Systems

Organizations such as RiskMetrics Group Institutional Shareholder Services ("RMG"), GovernanceMetrics International ("GMI"), the Corporate Library, Moody's Investors Service ("Moody's") and Morningstar developed corporate governance ratings.ⁿ⁴ In 2001, RMG began developing a metric for analyzing and comparing the corporate governance structures of public companies, and it launched its Corporate Governance Quotient ("CGQ") as a subscription service in 2002.ⁿ⁵ The Corporate Library introduced a proprietary "Board Analyst" system to evaluate the effectiveness of directors and assess litigation, liability, and investment risk.ⁿ⁶ Additionally, analysts have also begun to take more interest in corporate governance. In late November 2002, Smith Barney started using RMG's governance ratings as part of its research, listing the governance scores of individual companies on research reports.ⁿ⁷ According to the CEO of GMI, Gavin Anderson, "[t]he demand [for corporate governance scoring systems] is reflective of the times."ⁿ⁸ Corporate governance ratings also are available to retail investors. For example, companies tout high scores in their SEC filings, and Yahoo! Finance now includes CGQ scores in the "Company Profile" of covered companies.ⁿ⁹

This trend suggests at least some corporate managers believe that a company's commitment to effective corporate governance will affect not only its stock price, but also its cost of raising capital in the market. Because analysts and investors are making the perceived quality of corporate governance a part of the risk assessment of investments, the market may well increase "the cost of capital for any company that does not demonstrate a commitment to transparency and to effective and independent oversight."ⁿ¹⁰

[2] Burgeoning Numbers of Governance-Related Shareholder Proposals

Another market response to the focus on corporate governance issues has been a record number of shareholder proposals and an unusually high number of majority votes on such proposals. According to the RiskMetrics Group's 2008 Postseason Report, 267 non-compensation governance-related shareholder proposals appeared on corporate ballots for 2008.ⁿ¹¹ This number was down slightly from 281 in 2007, likely because a number of activist shareholders shifted their focus to compensation-related proposals, and a large number of governance-related proposals filed by retail shareholders were omitted pursuant to the SEC's no-action letter process.ⁿ¹² Governance-related shareholder proposals fared well in 2008, receiving average support of approximately 42% of votes cast. The number and level of support for governance-related shareholder proposals represents increasing investor pressure on companies to adopt good corporate governance practices.

A recent trend in shareholder proposals has been to request that companies eliminate their classified board structure and elect directors annually. In 2008, such declassification proposals were voted on at 76 companies, and received average support of approximately 67% of votes cast.ⁿ¹³ Another trend has been to request that boards eliminate all supermajority voting requirements, which are considered a form of anti-takeover protection. In 2008, these shareholder proposals were voted on at twelve companies and received average support of approximately 59% of votes cast.ⁿ¹⁴

In the future, it is likely that there will be an increased number of shareholder proposals related to corporate governance, and it is increasingly likely that even when such proposals are not approved by a majority of shareholders, companies that disregard these expressions of investor sentiment may face adverse consequences. Though proposals that pass may be non-binding, boards that value positive investor relations will want to give them substantial consideration. This is evidenced by the RMG policy of recommending that votes be withheld or voted against members of boards that do not implement shareholder proposals receiving a majority of votes cast two years in a row or the majority of votes outstanding in any single year.

[3] Director and Officer Liability Insurance

The Sarbanes-Oxley Act's increased corporate responsibilities and corporate scandals have added to the challenges for companies and their directors' and officers' (D&O) liability insurers. Even before the new regulations were adopted, both the frequency and severity of D&O claims had risen sharply.ⁿ¹⁵

According to the Towers Perrin 2007 Directors & Officers Liability Survey, however, the D&O insurance market has been softening since 2004.ⁿ¹⁶ The frequency of claims decreased in both 2006 and 2007 after a substantial increase in 2005.ⁿ¹⁷ However, the average size of claims increased significantly from \$4.26 million in 2006 to \$12.23 million in 2007.ⁿ¹⁸ This increase in the size of claims in 2007 is counter to a trend of successive decreases over several years, excepting 2005, in which, for example, the average indemnity for shareholder claims dropped to \$11.44 million in 2004 compared with \$14.20 million in 2003 and \$23.35 million in 2002.ⁿ¹⁹ Premiums decreased for the fourth consecutive year in 2007.ⁿ²⁰ Premiums paid by for profit companies stood at an average of approximately \$805,000 in 2007, almost a 35 percent decrease from the 2003 high of approximately \$1,237,000.ⁿ²¹ However, the financial crisis and difficulties experienced by some insurers have led to higher premiums for companies in the financial services sector, and some tightening of the market for a broader range of companies is expected.ⁿ²²

It has become clear in the past few years that D&O insurers consider governance practices in both underwriting and pricing decisions. Companies that do not practice good governance to current standards can expect the imposition of more stringent policy limits and higher premiums.ⁿ²³

D&O underwriters, like rating agencies, stock analysts and others, increasingly are inquiring as to whether companies have an adequate system in place to monitor and manage risk. One commenter observed "If companies have the opportunity to execute on the best practices of [the Sarbanes-Oxley Act] and corporate governance, but do not because

of the cost, the likely result will be rising loss costs for the D&O industry in the near future."²⁴ It is likely that the D&O insurance industry will continue to maintain tougher standards for underwriting, even for companies that are actually considered good risks. Against this background, boards and especially audit committees with underqualified or indifferent members will warrant higher D&O premiums,²⁵ as they will be viewed as less reliable monitors of corporate compliance.²⁶ D&O premiums will also reflect the greater risks presented by directors with histories of securities law violations. As insurers grow increasingly selective as to which risks qualify for full coverage, corporations with less rigorous governance practices may find it difficult to secure the D&O insurance they desire.²⁷ Conversely, companies evidencing a commitment to effective and independent oversight may benefit from a "good student discount" of sorts in the D&O insurance arena.

Because the enactment of the Sarbanes-Oxley Act generated additional responsibilities and the possibility of new liabilities for corporate officials, directors are likely to consider the availability of comprehensive D&O insurance with adequate limits as a significant factor in deciding whether to join or remain on a board. According to the Towers Perrin survey, in 2007, approximately 66 percent of public and 65 percent of private companies surveyed received inquiries from potential directors about D&O insurance.²⁸ As a result, in the past few years, companies have increasingly begun purchasing multiple layers of coverage with a view toward affording directors extra protection. This type of supplemental D&O insurance generally provides a certain amount of excess insurance coverage and can be structured so that it is non-rescindable. Some types of supplemental coverage "drop down" to provide coverage in specified circumstances where the underlying insurance is unable or unwilling to pay.²⁹ In the future, we are likely to continue seeing heightened demand for comprehensive insurance coverage, including the use of supplemental insurance policies, to help protect directors who are increasingly concerned about exposing themselves to untenable personal liability as a result of their service on a board.³⁰

[4] Debate over the Methods for Electing Corporate Directors

Another reflection of the temper of the times is efforts by shareholders seeking greater input in the governance of public companies, which is most evident in proposals to alter the ways in which corporate directors are elected. First, on October 14, 2003, the Securities and Exchange Commission (the "SEC" or the "Commission") published proposed amendments to its proxy rules that would have granted large shareholders or shareholder groups access to companies' annual proxy statements to nominate up to three directors in opposition to management nominees.³¹

Though the Commission has considered adoption of similar rules on at least three previous occasions dating back to the 1940s, this is the first time that the Commission actually proposed rules allowing direct shareholder access to the corporate proxy statement. However, the Commission never acted on the proposed rules, and even former Chairman Donaldson has acknowledged, "Probably, the proposal we put forward was too convoluted, too complicated."³²

The possibility of shareholder proxy access was revived in 2006 by the U.S. Court of Appeals for the Second Circuit in *American Federation of State, County and Municipal Employees v. American International Group, Inc. (AFSCME v. AIG)*.³³ In *AFSCME v. AIG*, the Court of Appeals held that proxy access bylaw shareholder proposals are not excludable under Rule 14a-8(i)(8).³⁴ In 2004, AFSCME submitted a proposal requesting that AIG include a proposed new bylaw in its 2005 proxy materials that, if adopted, would require AIG to include in its proxy statement the names of shareholder-nominated director candidates.³⁵ The SEC concurred in the exclusion of the proposal under Rule 14a-8(i)(8) on the basis that it "relates to an election."³⁶ AFSCME brought suit to compel AIG to include the proposal in its proxy statement.³⁷ In an amicus brief, the Commission set forth its interpretation of Rule 14a-8(i)(8) that the election exclusion applies to proxy access bylaw proposals because such proposals "would result in contested elections."³⁸ Disagreeing with the Commission, the Court of Appeals found the rules to be ambiguous and interpreted the election exclusion to apply to shareholder proposals relating to a particular board seat in an upcoming election and not to proposals that would establish the procedural rules governing elections generally even though they might make election contests more likely.³⁹

In July 2007, responding to the *AFSCME v. AIG* litigation, the Commission, by a divided vote, published two new alternative proposals on the subject.ⁿ⁴⁰ The first proposal was to amend Rule 14a-8(i)(8) to codify the SEC's historical interpretation that all proxy access shareholder proposals are excludable.ⁿ⁴¹ The second proposal was to amend Rule 14a-8(i)(8) to permit the inclusion of certain proxy access shareholder proposals and to require additional disclosures by proponents and companies when such proposals are included. Specifically, under the second SEC proposal, a proxy access shareholder proposal would not have been excludable under Rule 14a-8(i)(8) if the shareholder proposal was binding, sought to amend the company's bylaws, the submitting shareholder(s) held at least 5 percent of the company's outstanding stock for at least one year, and the submitting shareholder(s) was eligible to, and had, filed a Schedule 13G with respect to the company.ⁿ⁴² On November 28, 2007, the SEC voted to adopt the first proposal, but not the second.ⁿ⁴³

Mary Schapiro, appointed in 2009 by President Obama to serve as SEC Chairman, stated at her confirmation hearings that the SEC needs to address the issue of proxy access once again in light of the current financial crisis. She subsequently stated: "This crisis has led many to raise serious questions and concerns about the accountability and responsiveness of some companies and boards of directors, to the interests of shareholders."ⁿ⁴⁴ Under Chairman Schapiro's leadership, by a three to two vote, on May 20, 2009, the Commission approved the publication of proposed amendments to the SEC's proxy rules to permit shareholders to nominate directors in a company's proxy materials.ⁿ⁴⁵ The proposals include: (1) a federal proxy access right that would preempt state law and a company's charter and bylaws; and (2) an amendment to Rule 14a-8 to permit proxy access shareholder proposals. The proposals were supported by Chairman Schapiro and Commissioners Elisse Walter and Luis Aguilar, with Commissioners Kathleen Casey and Troy Paredes indicating they could not support the proposals.

Proposed Rule 14a-11 would create a federal law process whereby one or more shareholders could nominate a director and have that nominee included in a company's proxy materials if they beneficially owned individually or in the aggregate at least a certain percentage of the company's voting shares (1% for large accelerated filers, 3% for accelerated filers and 5% for non-accelerated filers) for at least one year. Shareholders would be permitted to include in a company's proxy materials each year the greater of one director nominee or a number of director nominees that equals up to 25% of the company's board. The director nominee would be required to satisfy the independence standards of the applicable national securities exchange or association.

However, proposed Rule 14a-11 (unlike prior proposed SEC rules on proxy access) would not restrict the ability of shareholders to nominate directors with whom they have a relationship, meaning shareholders could nominate themselves or their employees, family members or business associates. The nominating shareholders would be required to file a new Schedule 14N reporting the percentage of shares beneficially owned, the period of time such shares had been beneficially owned, their intent to hold their shares through the date of the meeting and certain other disclosures (*i.e.*, regarding litigation and certain relationships with the company). A company would be required to include in its proxy materials the same information on the nominating shareholder and the director nominee as required in proxy materials related to contested elections. Additionally, proposed Rule 14a-9(c) would make the nominating shareholder liable for false or misleading statements supplied to a company and provide that a company would not be liable for false or misleading information it received from a nominating shareholder or director nominee, unless the company knew or had reason to know the information was false. Significantly, the federal right provided in proposed Rule 14a-11 would preempt any proxy access provisions set forth in applicable state law or in a company's charter or bylaws unless any of those provisions prohibited director nominations by shareholders.ⁿ⁴⁶

The SEC also proposed to amend Rule 14a-8(i)(8) to require companies to include in their proxy materials shareholder proposals to amend a company's governing documents to address nomination rights or the disclosures or procedures related to shareholder nominations unless the shareholder proposals conflict with proposed Rule 14a-11 or state law.ⁿ⁴⁷ Thus, the proposed rules would permit shareholder proposals seeking to give greater rights of access for shareholders than what is provided under the new SEC Rule 14a-11, but could not, for example, set higher thresholds than the federal rule or establish director qualification standards beyond the minimum standards of the stock exchange where a

company's shares are traded.

In addition to the SEC's proxy access proposals, action taken at the state level addressed proxy access. Amendments to the Delaware General Corporation Law, adopted in April 2009 and effective August 1, 2009, include a new Section 112 that permits (but does not require) a corporation to include a provision in its bylaws providing shareholder access to its proxy materials with respect to the election of directors by including in the corporation's proxy materials one or more individuals nominated by a shareholder, in addition to individuals nominated by the board of directors.ⁿ⁴⁸ The bylaws may condition the obligation to include shareholder nominees on the satisfaction of eligibility requirements and/or compliance with procedures set forth in the bylaws. Among other things, these procedures or conditions may include a minimum record or beneficial ownership, or duration of ownership, submission of background information, restrictions on numbers of directors nominated, restrictions on acquisitions of shares of the corporation, a requirement that the shareholder indemnify the corporation in respect of losses arising from information submitted by the stockholder or any other conditions permitted by law. An American Bar Association committee, with jurisdiction over the Model Business Corporation Act ("MBCA"), also drafted amendments to the MBCA similar to the Delaware law changes and is expected to publish its proposals for comment in 2009.

Moreover, on May 19, 2009, U.S. Senators Charles Schumer and Maria Cantwell introduced new corporate governance legislation entitled the "Shareholder *Bill of Rights* Act of 2009" (the "Schumer Bill").ⁿ⁴⁹ Among other things, the Schumer Bill would confirm the SEC's authority to permit shareholders to nominate directors in company proxy materials and would provide that any proxy access rule established by the SEC may not allow such nominations unless the nominating shareholders beneficially owned at least 1% of the company's shares for at least two years.ⁿ⁵⁰ A similar bill was introduced in the House of Representatives on June 12, 2009 by U.S. Representative Gary Peters. The bill, entitled the "Shareholder Empowerment Act of 2009,"ⁿ⁵¹ would require the SEC to adopt rules requiring that companies allow shareholders to vote on director candidates nominated by shareholders holding at least 1% of the company's shares for at least two years. These rules would only be applicable when shareholders nominate less than a majority of directors authorized to serve on the board.

Perhaps in part as a result of the failure of the SEC to adopt rules to date, many shareholders and commentators have been calling for a move from plurality to majority voting in director elections and a growing number of companies have made that change.ⁿ⁵² Over 57 percent of companies in the Fortune 500 and 66 percent of companies in the S&P 500 had adopted either majority voting or modified plurality voting with a policy that required directors to do not receive a majority favorable vote to offer to resign.ⁿ⁵³ Significantly, for the first time, in 2008 a director who did not receive a majority favorable vote offered to resign on the spot at the company's annual meeting, and the board accepted the resignation.ⁿ⁵⁴

During the 2006 proxy season, companies received more than 150 shareholder proposals requesting that they elect directors based on a majority of votes cast; at least 39 such proposals received majority votes.ⁿ⁵⁵ Many majority voting proposals were submitted by building trade unions, including the United Brotherhood of Carpenters and Joiners of America (UBCJA), which submitted at least 66 of these proposals.ⁿ⁵⁶ During the 2007 proxy season, over 150 such proposals were again filed; however, at least 70 were withdrawn before a vote, usually as the result of the company's decision to preempt consideration by amending its bylaws to allow for majority voting.ⁿ⁵⁷

During the 2008 proxy season, the number of majority voting proposals submitted to companies dropped to approximately 90, more than half of which were withdrawn before a vote.ⁿ⁵⁸ The decrease likely was in response to the increase in the number of companies adopting majority voting since 2007.ⁿ⁵⁹ RiskMetrics Group (RMG) and Glass, Lewis & Co., Inc., both of which are proxy advisory firms, as well as the California Public Employees' Retirement System (CalPERS) and the Council of Institutional Investors supported these precatory majority voting proposals.ⁿ⁶⁰ In addition, the American Bar Association's Committee on Corporate Laws established a task force to examine whether to revise the Model Business Corporation Act (which a majority of U.S. states follow in whole or in part) with respect to voting for directors. To assist this effort, the Committee on Corporate Laws published a *Discussion Paper On Voting By*

Shareholders for the Election of Directors, which invited public comment.ⁿ⁶¹ The ABA Committee ultimately decided to revise the Act in June 2006. Rather than changing the statutory plurality default rule, the revised Act permits shareholders or the Board of Directors at individual companies to adopt a majority voting bylaw standard.ⁿ⁶²

In response to these calls for majority voting in director elections, many companies have adopted either a majority voting standard, a director resignation policy, or some combination of the two. Under a director resignation policy a company retains plurality voting but requires that any director nominee who receives a greater number of votes "withheld" from his or her election than votes "for" such election will tender a resignation for consideration by the Board. While majority voting proposals at companies with director resignation policies received considerable support in 2006, these proposals tended to be defeated at companies with director resignation policies.ⁿ⁶³ By February 2007, over 52 percent of S&P 500 companies had adopted some form of majority voting compared to fewer than 20 percent in February 2006, with a majority of these companies choosing to adopt director resignation policies.ⁿ⁶⁴ However, since February 2006, the percentage of companies opting to adopt director resignation policies has been declining, while the percentage of companies choosing to adopt majority voting bylaw provisions has been steadily increasing.ⁿ⁶⁵ As earlier discussed, Business Roundtable's Annual Corporate Governance Survey of 2008 found that 75 percent of Roundtable members now have some form of majority voting for directors, up from a handful just three years before.ⁿ⁶⁶ This trend continues.

The SEC's proposed director election rules and the movement for majority voting indirectly have made companies more concerned about the need to communicate with shareholders about the director elections process. A March 2006 Business Roundtable survey of corporate governance found that 83 percent of Roundtable members indicated that their nominating/governance committees had developed a process "for communicating with/responding to shareholder [suggestions for] nomination[s] of board candidates," up from 78 percent in the 2004 survey and 75 percent in 2003.ⁿ⁶⁷ By 2006, 91 percent of companies surveyed had established procedures for shareholder communications with directors,ⁿ⁶⁸ and the 2007 survey reports that at least one director at 38 percent of the Business Roundtable member companies reported having met with shareholders during the year.ⁿ⁶⁹ Moreover, a few companies have voluntarily implemented many of the director election reforms suggested in the proposed rules and by recent shareholder proposals. For example, Apria Healthcare Group Inc., a New York Stock Exchange ("NYSE") listed company and one of the largest home health care firms in the U.S., voluntarily adopted a policy providing large shareholders with access to the company's proxy materials to nominate up to two directors.ⁿ⁷⁰ According to its non-executive board chairman, Apria's move reflected the prevalence of the belief "that corporate America must improve board room dynamics."ⁿ⁷¹ Revisions to the NYSE and NASDAQ corporate governance listing standards with respect to nominating committees similarly have transformed the method of electing directors. For example, one recruiter indicated that five years ago the chief executive was the client in 95 percent of the searches for new directors while today the nominating committee is the client over half of the time.ⁿ⁷²

Activity during recent proxy seasons demonstrated, in many respects, a more constructive dialogue between shareholders and corporations.ⁿ⁷³ Boards of directors implemented many shareholder proposals that garnered majority or even significant votes relating, for example, to poison pills and staggered boards, and other shareholder proposals were withdrawn.ⁿ⁷⁴ Many companies also established lead and presiding director positions, which include job criteria recommended by RMG.ⁿ⁷⁵ In 2007, Pfizer Inc. invited its large institutional investors to meet with members of the board of directors to get feedback on the company's corporate governance and executive compensation practices.ⁿ⁷⁶ In 2008, the National Association of Corporate Directors published a Blue Ribbon Commission Report on board-shareholder communications, which included best practice recommendations for optimizing these communications.ⁿ⁷⁷

[5] Accounting and Auditing Practices Will Continue to Evolve

Perhaps the most criticized provision in the Sarbanes-Oxley Act was Section 404, which requires management to assess the effectiveness of company internal financial controls and requires auditors to attest whether they are able to agree

with management's assessment based on their own audit of control effectiveness.ⁿ⁷⁸ Section 404 took effect in 2005 for U.S. companies with market capitalizations greater than \$75 million.ⁿ⁷⁹ In that first year, approximately 16 percent of companies required to comply with Section 404 reported having material weaknesses. That percentage was halved, however, in 2006.ⁿ⁸⁰

The primary criticism of Section 404 has been the significant implementation costs. On average, companies' audit fees increased 64 percent in fiscal year 2004 over the prior year to an average of nearly \$9 million per company (up from an average of \$3.8 million in 2001).ⁿ⁸¹ Public Company Accounting Oversight Board (PCAOB) Chairman William McDonough acknowledged "the first round of internal control audits cost too much."ⁿ⁸² In response to this criticism, in April 2005, the SEC hosted a roundtable to discuss this issue and, in May 2005, the PCAOB issued a policy statement that purported to interpret its standard so as to reduce costs.ⁿ⁸³ Also in May 2005, the SEC issued guidance addressing various issues implicated by the Section 404 process.ⁿ⁸⁴ In December 2006, the SEC proposed interpretive guidance for management to use in conducting the annual evaluation of internal control over financial reporting that is required under Section 404.ⁿ⁸⁵ According to then-Chairman Christopher Cox, the SEC proposed the interpretive guidance, premised on a "top-down, risk-based" approach, with the hope of making the Section 404 evaluation process "more efficient and cost-effective."ⁿ⁸⁶ And in May of 2007, the SEC adopted the Section 404 interpretive guidance for management to use in conducting the annual evaluation of internal control over its financial reporting. The Section 404 guidance provides that management should identify both the potential risks to the quality of financial reports and the controls in place to manage those risks. The guidance further provides that once the controls are identified, management should focus its analysis on controls that concern the highest risk areas for financial reporting.ⁿ⁸⁷

Also in May of 2007, PCAOB adopted Auditing Standard No. 5 (AS-5) to supersede Auditing Standard No. 2 (AS-2).ⁿ⁸⁸ AS-5 is intended to align the costs and benefits of internal control audits by scaling audits to the size of the company and allowing auditors to focus on those controls which are most important to ensuring reliable financial reporting.ⁿ⁸⁹ AS-5 differs from AS-2 in several ways. As stated, AS-5 focuses auditors on those controls deemed critical to preserving the integrity of the company's financial reporting. AS-5 also clarifies that auditors are not required to evaluate management's own evaluation process. AS-5 further provides commentary throughout the standard to explain how examinations can be scaled to the size and complexity of the company being audited. Moreover, AS-5 clarifies the appropriate materiality standard to apply in the context of internal audits. Auditors are required to use AS-5 for all internal control audits conducted on companies whose fiscal years end on or after November 15, 2007.ⁿ⁹⁰

The SEC, on June 20, 2007, amended the rules regarding the management report on internal control over financial reporting (ICFR). As announced in the release, though AS-5 does not require auditors to provide an opinion on the management report, auditors are required to assess whether the management report fully discloses the requisite information and, if they determine that the management report is not fairly stated, to modify their reports on the effectiveness of ICFR.ⁿ⁹¹

The SEC final rule concerning ICFR requires a non-accelerated filer to begin filing its management report with the first annual report for a fiscal year ending on or after December 15, 2007.ⁿ⁹² The final rule also requires a non-accelerated filer to file its auditor attestation report with the first annual report for a fiscal year ending on or after December 15, 2008.ⁿ⁹³ However, the SEC announced in June 2008 that it had approved a one-year extension of the compliance date for non-accelerated filers to meet the auditor attestation requirement. With the extension, non-accelerated filers will be required to provide the attestation reports in their annual reports for fiscal years ending on or after December 15, 2009.ⁿ⁹⁴

In response to significant concern over the adequacy of disclosures about post-retirement benefits, in September of 2006, FASB released FAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, requiring an employer that sponsors a single-employer defined benefit postretirement plan to report the overfunded or underfunded status of the plan in its statement of financial position rather than in the notes. For employers with publicly traded equity securities, the requirement to reflect the funded status of a benefit plan in its financial statements and the

disclosure requirements were effective as of the end of the fiscal year ending after December 15, 2006.ⁿ⁹⁵

On March 12, 2009, the House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Entities held a hearing addressing the fair value accounting rules that some have identified as a factor contributing to the financial crisis.ⁿ⁹⁶ FAS 157, which was issued in September 2006 in response to confusion resulting from the widely differing methodologies used by preparers in determining fair values, does not itself establish that fair value accounting must be used to value certain assets. Rather, it creates a framework for applying fair value accounting where such accounting is required.ⁿ⁹⁷ FASB, as well as the SEC, had issued guidance on the application of FAS 157 at various points during 2008 and in early 2009. Nevertheless, during the March 12th hearings, members of the subcommittee called on FASB to act quickly to issue additional, enhanced guidance under FAS 157, warning that Congress would take action if FASB did not do so in a timely fashion. FASB responded to this Congressional pressure on March 17, 2009 by proposing FSP FAS 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed*, which provides further clarification on the application of FAS 157. On April 2, 2009, FASB voted to prepare a final draft of this guidance. The new guidance will be effective prospectively for interim and annual periods ending after June 15, 2009.

[6] Absent Federal Legislation, Market Demand Likely Would Have Mandated Many of the Sarbanes-Oxley Reforms

One impact of the Sarbanes-Oxley Act "has been the all-but-instant appearance of literally dozens of firms, seminars, consultants, and publications, all designed to solve (for a healthy fee) all worries associated with [Sarbanes-Oxley] compliance."ⁿ⁹⁸ The actual utility of some of these services is questionable--in many cases, the recommendations of such consultants may become just another group of items on a compliance checklist for the board and its committees. There is no substitute for a board's active oversight of management in the development of a plan for compliance with the mandates of Sarbanes-Oxley that fit the company and its culture. However, "even full compliance with [Sarbanes-Oxley], with or without the help of outsiders, is likely to have more form than substance."ⁿ⁹⁹ One reason is that by history and policy, corporate governance in the U.S. is still primarily the province of state law, with a limited role for federal government, which focuses mostly on disclosure and process rather than substance.ⁿ¹⁰⁰ However, the recent financial crisis may be changing this dynamic somewhat as Congress increasingly has been focusing on legislation affecting executive compensation and corporate governance.ⁿ¹⁰¹

Although the passage of the Sarbanes-Oxley Act represents the largest federal incursion into state law control of corporate governance to date, even without federal legislation it is likely that market demand would have required implementation of some of the Sarbanes-Oxley requirements such as audit partner rotation,ⁿ¹⁰² attestation provisions,ⁿ¹⁰³ the reduction of organizational and incentive compensation conflicts of interest for securities analystsⁿ¹⁰⁴ and the prohibition of some auditor consulting services.ⁿ¹⁰⁵ In fact, a number of companies had voluntarily adopted some or all of the Sarbanes-Oxley and listing standards mandates, even before they were enacted or adopted, in the form of best practices for corporate governance, both to demonstrate their commitment to good governance and to avoid being penalized by investors who were wary of questionable governance structures.ⁿ¹⁰⁶ A company's voluntary pledge to "do the right thing" often proved instrumental in restoring investor confidence and proving that a particular company was not a "lemon."ⁿ¹⁰⁷

In addition, some institutional investors, acting as lead plaintiffs in class action securities suits under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"),ⁿ¹⁰⁸ have sought and achieved corporate governance enhancements as part of negotiated settlements. For example, Homestore (now Move, Inc.), an Internet real estate company, settled a class action suit brought by the California State Teachers' Retirement System ("CalSTRS") in August 2003, paying out \$64 million in cash and stock to shareholders and consenting to several corporate governance reforms.ⁿ¹⁰⁹ Homestore agreed to appoint a shareholder-nominated director to the board, ban the use of stock options in director compensation, increase the number of independent directors and committees, and gradually eliminate staggered terms for directors.ⁿ¹¹⁰ As the result of another class action settlement, Siebel Systems, Inc., a provider of

customer-service software, agreed to adopt limits on director compensation and add a new outside director selected with input from the Teachers' Retirement System of Louisiana, a \$10 billion retirement fund that was acting as lead plaintiff in the suit.ⁿ¹¹ Hanover Compressor also settled a shareholder lawsuit in May 2003 by agreeing to rotate its outside audit firm every five years, implement certain restrictions on insider stock sales and permit shareholders with more than 1 percent of the outstanding shares to nominate director candidates.ⁿ¹² In 2005, Ashland Inc. settled a class action lawsuit with the Central Laborers' Pension Fund that provides the plaintiff increased input with respect to director nominations, requires the company to appoint a lead independent director, and mandates that directors accept at least 50 percent of their director fees in Ashland common stock and defer at least 50 percent of their director fees into hypothetical common stock units of Ashland common stock.ⁿ¹³ Tyson Foods settled a shareholder lawsuit in January 2008 by, among other things, agreeing to appoint a lead independent director and to replace at least one inside director with an independent director.ⁿ¹⁴

Though it initially took some time for the market to react to the incentives created by the PSLRA, institutional investors have become increasingly active in securities class actions, often achieving settlements including significant governance enhancements.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Governing Documents & Procedures General Overview Business & Corporate Law Corporations Shareholders Meetings & Voting General Overview Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares Director Elections & Removals Insurance Law Business Insurance Directors & Officers Liability Insurance General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. According to a 2006 ISS study, 94 percent of the 320 institutional investors interviewed said that a company's corporate governance structure is important to their firms. *See* ISS 2006 Global Institutional Investor Study, available at <http://www.issproxy.com/globalinvestorstudy/index.jsp>. A July 2002 global survey of 200 institutional investors performed by McKinsey & Co. found that: "Corporate governance is at the heart of investment decisions. Investors state that they still put corporate governance on par with financial indicators when evaluating investment decisions. An overwhelming majority of investors are willing to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14 percent in North America and Western Europe." House Committee on Financial Services, *Rebuilding Investor Confidence, Protecting U.S. Capital Markets, The Sarbanes-Oxley Act: The First Year*, 12 (2003).

In fact, institutional investors have increasingly moved to stocks of companies perceived as being well-governed, penalizing stocks of companies seen as having lax oversight. For example, Cendant Corp. overhauled its governance structure after a 1998 accounting scandal. In the words of Cendant's CEO, Henry R. Silverman, "I think the real impetus [for reform] will not be the NYSE, the President, or Congress--it will be the reality of the marketplace." Louis Lavelle, *The Best & Worst Boards, How the Corporate Scandals are Sparking a Revolution in Governance*, Bus. Wk., Oct. 7, 2002, at 112 (stating that "perhaps the most important driver of change [in governance] is the markets").

(n2)Footnote 2. Additionally, several shareholder advocacy groups, blue ribbon panels and other associations have suggested a set of "best practices" for improving board performance that they urge boards to adopt.

See e.g., Business Roundtable, Principal of Corporate Governance (November 2005), available at <http://www.businessroundtable.org/sites/default/files/CorporateGovPrinciples.pdf> and reproduced in Appendix A to this treatise; Council of Institutional Investors, Corporate Governance Policies (October 7, 2008), available at [http://www.cii.org/UserFiles/file/council%20policies/CII%20Corp%20Gov%20Policies%2010-7-08\(1\).pdf](http://www.cii.org/UserFiles/file/council%20policies/CII%20Corp%20Gov%20Policies%2010-7-08(1).pdf); CalPERS,

Global Principles of Accountable Corporate Governance (March 1, 2009) *available at* <http://www.calpers-governance.org/docs-sof/marketinitiatives/2009-04-01-corp-governance-pub20-final-glossy.pdf>; Jeffrey Sonnenfeld, Meet Our Corporate Governance Watchdogs, *Wall St. J.*, Mar. 11, 2003, at B4; Korn/Ferry International, Twenty "Best Practices" to Improve Board Performance, *available at* www.kornferry.com/Library/ViewGallery.asp?CID=294&LanguageID=1&RegionID=23; The Conference Board, *Corporate Governance Handbook 2007: Legal Standards and Board Practices* (July 2007); TIAA-CREF, Policy Statement of Corporate Governance (March 13, 2007) *available at* http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf; The Aspen Institute, Long-Term Value Creation: Guiding Principles for Corporations and Investors (June 2007) *available at* http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F84-8DF23CA704F5%7D/BSP_PRINCIPLESFINALJUNE2007.PD

(n3)Footnote 3. *See, e.g.,* Moody's Global Corporate Governance, *Corporate Governance in the Credit Crisis: Key Considerations for Investors* (Nov. 2008).

(n4)Footnote 4. *See, e.g.,* www.isscgq.com/abouttheratings.htm; www.dnv.com.my/certification/corporateresponsibility/; www.governancemetrics.com/; www.thecorporatelibrary.net/products/ratings2003.html; www.moody.com; http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/MorningstarStwrdshpGrade_FactSheet.pdf.

(n5)Footnote 5. Matthew Brown, *Companies Must Seek to Avoid the "Junk" Governance Rating*, 11 *The Corporate Governance Advisor* 1 No. 3 (May/June 2003). "As a result of the changing corporate governance environment," RMG revised the Corporate Governance Quotient in July 2005 "to ensure that our scoring criteria are aligned with best practices and financial performance metrics," and has announced that it plans a further revision prior to the 2010 proxy season, *available at* www.issproxy.com/cgq/evolve.jsp.

(n6)Footnote 6. The "Board Analyst" system developed by the Corporate Library is described on the firm's website, *at* www.thecorporatelibrary.com/Products-and-Services/board-effectiveness-ratings.html.

(n7)Footnote 7. Ian Sax, *Ratings Game*, *IRontheNet.com*, February 2003, *available at* http://www.thecrossbordergroup.com/ir_archive/pages/828/February+2003.stm?article_id=9989.

(n8)Footnote 8. Ian Sax, *Ratings Game*, *IRontheNet.com*, February 2003, *available at* http://www.thecrossbordergroup.com/ir_archive/pages/828/February+2003.stm?article_id=9989.

(n9)Footnote 9. *See* Yahoo! Help, <http://help.yahoo.com/l/us/yahoo/finance/tools/forms/research-57.html/>.

(n10)Footnote 10. Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, *Pub. Aff. Rev.* 10, 11 (2003), *available at* www.pac.org/pages/annual_report_2003.pdf.

(n11)Footnote 11. *See Introduction*, RiskMetrics Group 2008 Postseason Report at 4.

(n12)Footnote 12. Subodh Mishra, *Support Edges Up for Most Governance Proposals*, RiskMetrics Group 2008 Postseason Report at 24.

(n13)Footnote 13. *Introduction*, RiskMetrics Group 2008 Postseason Report at 4, 5.

(n14)Footnote 14. *Introduction*, RiskMetrics Group 2008 Postseason Report at 4, 5.

(n15)Footnote 15. *See* William Cotter, Jr., *The Changing State of D&O Insurance*, 11 *The Corp. Governance Advisor* No. 1, at 8-10 (Jan./Feb. 2003). *See also* John F. Olson & Josiah O. Hatch III, *Director and Officer Liability: Indemnification and Insurance* § 10.02 (West Group 1997-2006); Robert Yellen, *Battling to Cover Corporates*, *Reactions* (May 2003), *available at* www.reactionsnet.com/default.asp?Page=5&ISS=4892.

(n16)Footnote 16. Towers Perrin 2007 Directors & Officers Liability Survey, *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf&cm_ven=Spop-Email

(n17)Footnote 17. Towers Perrin 2007 Directors & Officers Liability Survey, *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf&cm_ven=Spop-Email
Towers Perrin 2006 Directors & Officers Liability Survey, *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=HRS/USA/2007/200704/DO_Survey_Report2006_040507.pdf; Towers Perrin 2005 Directors & Officers Liability Survey, *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200601/DO_2005_Exec_Sum.pdf.

(n18)Footnote 18. Towers Perrin 2007 Directors & Officers Liability.

(n19)Footnote 19. Towers Perrin 2004 Directors & Officers Liability Survey, *available at* http://www.towersperrin.com/tillinghast/publications/reports/2004_D_O/2004_DO_Exec_Sum.pdf.

(n20)Footnote 20. *Id.* at 32-33 ; Towers Perrin 2007 Directors & Officers Liability Survey.

(n21)Footnote 21. *Id.*

(n22)Footnote 22. *See, e.g.,* Zach Phillips, *Prices Firming Across D&O Sector*, Business Insurance (Mar. 16, 2009) (stating that there was a 50% increase in D&O pricing in the financial services sector between the fourth quarter of 2007 and the fourth quarter of 2008, while pricing among all sectors increased only 3%); Kevin LaCroix, *The D&O Diary: November Securities Lawsuit Filings Continue Upward Trend* (Dec. 2, 2007), *available at* http://dandodiary.blogspot.com/2007_12_01_archive.html (stating that "[w]ithout a doubt, the D & O insurance environment for financial institutions has changed, where renewals have become more challenging, pricing (for financial institutions) has moved higher than even a short time ago, and underwriting has become much more rigorous.").

(n23)Footnote 23. We note that a company's governance practices are only one of many factors considered by D&O insurers when determining coverage and premium fees. For further discussion of D&O insurance, *see* Chapter 5 *below*.

(n24)Footnote 24. *Current Trends in D&O Insurance*, Journal of Investment Compliance (Fall 2004).

(n25)Footnote 25. Companies with "corporate governance red flags may face, at best, bigger premium increases or more restrictive coverage terms on renewal." Michael L. Gassmann, *D&O Insurance After Enron*, 10 The Corporate Governance Advisor No. 3, at 27, 29 (May/June 2002).

(n26)Footnote 26. Note that Section 407 of the Sarbanes-Oxley Act imposes only a disclosure requirement, not a substantive requirement, with respect to having a financial expert on a company's audit committee. *See 15 U.S.C. § 7265 (2000)*.

(n27)Footnote 27. *See* Towers Perrin, Directors and Officers Liability, 2006 Survey of Insurance Purchasing and Claims Trends 56, *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=HRS/USA/2007/200704/DO_Survey_Report2006_040507.pdf (stating that "D&O insurers' use of independent corporate governance ratings as part of their underwriting has grown" and that "[g]ood corporate governance may reduce both the liability risk and the premium an underwriter will charge for D&O insurance"); *see also* Fred T. Podolsky & Susanne Murray, Hilb Rogal & Hobbs, *2005 Directors and Officers Liability Snapshot and Insurance Market Forecast 7*, *available at* <http://www.directorsandboards.com/DBEBRIEFING/JANUARY2005/DO2005FORECAST.PDF> ("Corporate governance is ... a focus of D&O underwriting and D & O risk evaluation.")

(n28)Footnote 28. Towers Perrin 2007 Directors & Offices Liability Survey.

(n29)Footnote 29. For a more detailed discussion of supplemental directors' liability insurance, *see* § 5.04[7] *below*.

(n30)Footnote 30. For example, surveys conducted by Korn/Ferry International found that the percentage of respondents in the nations comprising the Americas who declined board invitations due to the risk of liability more than doubled from 13% in 2002, when Sarbanes-Oxley became law, to 29% in 2004, and almost doubled again from 2004 to 2008, when 59% of respondents reported that they had declined a board seat due to the risks involved. *See* Korn/Ferry International's 31st Annual Board of Directors Study, *available at* www.kornferry.com/Library/Process.asp?P=PR_Detail&CID=840&LID=1; Korn/Ferry International's 32nd Annual Board of Directors Study, *available at* www.kornferry.com/Library/Process.asp?P=PR_Detail&CID=1419&LID=1; Korn/Ferry International's 33rd Annual Board of Directors Study, *available at* http://www.kornferry.com/Library/Process.asp?P=Pubs_Detail&CID=3025&LID=1; Korn/Ferry International's 34th Annual Board of Directors Study, *available at* http://www.kornferryinstitute.com/files/pdf1/Board_Study07_LoRez_FINAL.pdf Similarly, a survey by Corporate Board Member magazine and PricewaterhouseCoopers found that 73% of directors participating in the 2005 annual What Directors Think survey believed that their risk as directors had increased in the last year, and 66% of directors said that they would increase their due diligence when considering whether to join a board in the future. *See* 2005 What Directors Think--The Corporate Board Member/PricewaterhouseCoopers Survey, *available at* [www.pwc.com/extweb/pwcpublishings.nsf/docid/870C33ACFC7C57C385256FA3007252CF/\\$file/cbm-wdt-2005.pdf](http://www.pwc.com/extweb/pwcpublishings.nsf/docid/870C33ACFC7C57C385256FA3007252CF/$file/cbm-wdt-2005.pdf).

(n31)Footnote 31. *See* SEC Release No. 34-48626 (Oct. 14, 2003), *available at* www.sec.gov/rules/proposed/34-48626.htm.

(n32)Footnote 32. *Donaldson Looks Beyond Proposal On Shareholder Nominations of Directors*, Securities Regulation & Law Report, Vol. 37, No. 8, Feb. 21, 2005 (remarks during a question and answer session following a speech to the Mutual Fund Directors Forum on February 16, 2005).

(n33)Footnote 33. *462 F.3d 121 (2d Cir. 2006)* .

(n34)Footnote 34. *462 F.3d 121 (2d Cir. 2006)* .

(n35)Footnote 35. *462 F.3d at 124* .

(n36)Footnote 36. *462 F.3d at 124* .

(n37)Footnote 37. *462 F.3d at 124* .

(n38)Footnote 38. *462 F.3d at 126* .

(n39)Footnote 39. *462 F.3d at 128* .

(n40)Footnote 40. *See* SEC Release No. 34-56161 (July 31, 2007), *available at* <http://www.sec.gov/rules/proposed/2007/34-56161.pdf>; SEC Release No. 34-56160 (July 31, 2007), *available at* <http://www.sec.gov/rules/proposed/2007/34-56160.pdf>.

(n41)Footnote 41. SEC Release No. 34-56161 (July 31, 2007).

(n42)Footnote 42. SEC Release No. 34-56160 (July 31, 2007).

(n43)Footnote 43. SEC Press Release 2007-246 (November 28, 2007), *available at*

<http://www.sec.gov/news/press/2007/2007-246.htm>.

(n44)Footnote 44. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Statement at SEC Open Meeting on Facilitating Director Nominations (May 20, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch052009mls.htm>.

(n45)Footnote 45. SEC Press Release 2009-116 (May 20, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-116.htm>.

(n46)Footnote 46. SEC Press Release 2009-116 (May 20, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-116.htm>.

(n47)Footnote 47. SEC Press Release 2009-116 (May 20, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-116.htm>.

(n48)Footnote 48. *See* Synopsis, House Bill No. 19 (Apr. 10, 2009), *available at* <http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19?Opendocument>.

(n49)Footnote 49. Shareholder *Bill of Rights* Act of 2009, *available at* <http://thomas.loc.gov/cgi-bin/bdquery/D?d111:36:./temp/bdtJ5y:|/bss/d111query.html>.

(n50)Footnote 50. *See Section 2.09, infra*, for further discussion of the Schumer Bill.

(n51)Footnote 51. Shareholder Empowerment Act of 2009, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2861ih.txt.pdf.

(n52)Footnote 52. At the SEC's March 2004 Roundtable on the proposed rules, E. Norman Veasey, the now retired Chief Justice of the Supreme Court of Delaware, suggested that the SEC consider exempting from the operation of the Proposed Director Election Rules any issuer who requires directors to be elected based on a majority of the votes cast. *See* <http://www.sec.gov/spotlight/dir-nominations/transcript03102004.txt>. In a follow-up letter to Alan Beller dated March 11, 2004, Chief Justice Veasey added that majority voting could be provided for in companies' certificates of incorporation or bylaws or instead required by states for companies incorporated therein. *See* <http://www.sec.gov/rules/proposed/s71903/s71903-768.pdf>.

(n53)Footnote 53. *See* Claudia H. Allen, *Majority Voting in Director Elections--An Activist Success Story*, Neal, Gerber & Eisenberg LLP Alert, Nov. 13, 2007.

(n54)Footnote 54. *See* Joseph Major, *WaMu Finance Chair Resigns Under Pressure*, International Business Times (Apr. 15, 2008), *available at* <http://www.ibtimes.com/articles/20080415/washington-mutual-wamu-mary-pugh.htm>. Mary Pugh, a director and chair of the finance committee of Washington Mutual Inc., resigned on April 15, 2008.

(n55)Footnote 55. *See* Claudia H. Allen, *Updated Study Reveals Majority Voting in Director elections Tops 50% Among S&P 500 as 2007 Proxy Season Gets Underway*, Neal, Gerber & Eisenberg LLP Alert, Feb. 7, 2007.

(n56)Footnote 56. *See* Claudia H. Allen, *Updated Study Reveals Majority Voting in Director elections Tops 50% Among S&P 500 as 2007 Proxy Season Gets Underway*, Neal, Gerber & Eisenberg LLP Alert, Feb. 7, 2007.

(n57)Footnote 57. *See* L. Reed Walton, *Investors Seek Greater Influence on Board Elections*, RiskMetrics Group 2007 Postseason Report at 3, *available at* <http://www.riskmetrics.com/pdf/2007PostSeasonReportFINAL.pdf>.

(n58)Footnote 58. *See* RiskMetrics Group, "2008 Post Season Report," Support Edges Up for Most Governance Proposals (2008), *available at* <https://gac.riskmetrics.com/newmain.php#>.

(n59)Footnote 59. *Id.*

(n60)Footnote 60. See RMG 2006 Policy Updates, available at <http://www.issproxy.com/policy/2006us/board.jsp#2>; Julie Connelly, *A Push for Majority Rule Roils the Boardroom*, Corporate Board Member, January/February 2006, available at http://www.boardmember.com/issues/archive.pl?article_id=12412&V=1; CII Majority Voting Primer, making Shareowners' Votes Count: Majority Voting in Director Elections, February 27, 2006, available at <http://www.cii.org/policies/MajorityVotingPrimer.pdf>.

(n61)Footnote 61. Available at www.abanet.org/buslaw/committees/CL270000pub/materials/20050621000000.pdf. Mr. Olson, a co-author of this chapter, was a member of the ABA Committee.

(n62)Footnote 62. See ABA press release, Committee on Corporate Laws Adopts Amendments to the Model Business Corporation Act Relating to Voting by Shareholders for the Election of Directors, June 20, 2006; see also Thaddeus C. Kopinski and Rosanna Landis Weaver, *Banner Year for Majority Elections*, ISS Governance Weekly, 2006, available at <http://www.issproxy.com/governance/publications/2006archived/175.jsp>.

(n63)Footnote 63. See Claudia H. Allen, *Updated Study Reveals Majority Voting in Director elections Tops 50% Among S&P 500 as 2007 Proxy Season Gets Underway*, Neal, Gerber & Eisenberg LLP Alert, Feb. 7, 2007.

(n64)Footnote 64. See Claudia H. Allen, *Updated Study Reveals Majority Voting in Director elections Tops 50% Among S&P 500 as 2007 Proxy Season Gets Underway*, Neal, Gerber & Eisenberg LLP Alert, Feb. 7, 2007.

(n65)Footnote 65. See Claudia H. Allen, *Updated Study Reveals Majority Voting in Director elections Tops 50% Among S&P 500 as 2007 Proxy Season Gets Underway*, Neal, Gerber & Eisenberg LLP Alert, Feb. 7, 2007.

(n66)Footnote 66. See Business Roundtable, Business Roundtable Corporate Governance Survey Trends, December 2008, available at <http://www.businessroundtable.org/sites/default/files/2008%20Corp%20Gov%20Survey%20Trends.pdf>; Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings, October 2007, available at <http://www.businessroundtable.org/publications/publication.aspx?qs=2A86BF807822B0F19D44484>; see also Allen, *Majority Voting in Director Elections--An Activist Success Story*.

(n67)Footnote 67. Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings, March 2006, available at http://www.businessroundtable.org/sites/default/files/Business_Roundtable_Corporate_Governance_.pdf.

(n68)Footnote 68. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings, March 2006, available at <http://www.businessroundtable.org/taskForces/taskforce/document.aspx?qs=6EB5BF159F949514481138A74FA1851159169FEB56A38>

(n69)Footnote 69. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings, October 2007, available at <http://www.businessroundtable.org/publications/publication.aspx?qs=2A86BF807822B0F19D44484>.

(n70)Footnote 70. See Press Release: *Apria Healthcare Announces Policy Allowing Stockholders to Nominate Directors* (June 11, 2003); Will Boye, *Apria Makes Room for Shareholder Nominees*, Institutional Shareholder Services, The Friday Report, June 13, 2003. Apria's policy for shareholder access provides, in part, that any stockholder or group of stockholders who have owned at least 5 percent of the company's stock for at least two years may use the company's proxy statement to solicit votes for up to two of the shareholders' directorial nominees in opposition to the management slate. See SEC Release No. 34-48301 (Oct. 8, 2003), available at

www.sec.gov/rules/proposed/34-48301.htm.

(n71)Footnote 71. Will Boye, *Apria Makes Room for Shareholder Nominees*, Institutional Shareholder Services, The Friday Report, June 13, 2003 (quoting a statement by Apria Chairman Ralph Whitworth).

(n72)Footnote 72. *Non-Executive Directors: Where's all the fun gone?*, The Economist, Issue 950, Mar. 20, 2004.

(n73)Footnote 73. See RiskMetrics Group, "2007 Post Season Report," Support for Board Declassification Holds Steady (2007), available at <http://www.riskmetrics.com/pdf/2007PostSeasonReportFINAL.pdf>.

(n74)Footnote 74. See RiskMetrics Group, "2008 Post Season Report," Support Edges Up for Most Governance Proposals (2008).

(n75)Footnote 75. See RiskMetrics Group, "2007 Post Season Report," Support for Board Declassification Holds Steady (2007).

(n76)Footnote 76. Pfizer, Inc. Press Release, *Pfizer Board of Directors to Initiate Face-to-Face Meeting with Company's Institutional Investors on Corporate Governance Policies and Practices* (June 28, 2007), available at http://mediaroom.pfizer.com/portal/site/pfizer/?ndmViewId=news_view&newsId=20070628005559&newsLang=en.

(n77)Footnote 77. National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Board-Shareholder Communications* (2008). Nell Minow and John Olsons, the authors of this chapter, both served on the Blue Ribbon Commission.

(n78)Footnote 78. Sarbanes-Oxley Act § 404, *15 U.S.C. § 78j* (2003).

(n79)Footnote 79. *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, SEC Release No. 34-47986 (Feb. 24, 2004, as subsequently amended).

(n80)Footnote 80. See Michael Gaynor, "Risk Based Evaluations of ICFR," speech before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (December 11, 2006), available at <http://www.sec.gov/news/speech/2006/spch121106mg.htm>.

(n81)Footnote 81. Andrew Countryman, *Sarbanes-Oxley mandates send corporate audit expenses soaring*, Chi. Trib., June 4, 2005 at C1.

(n82)Footnote 82. Andrew Countryman, *Sarbanes-Oxley mandates send corporate audit expenses soaring*, Chi. Trib., June 4, 2005 at C1.

(n83)Footnote 83. *Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements*, PCAOB Release No. 2005-009 (May 16, 2005), available at www.oversightsystems.com/pdfs/PCAOB_PolicyStatement05162005.pdf.

(n84)Footnote 84. *Staff Statement on Management's Report on Internal Control Over Financial Reporting*, May 16, 2005, available at www.sec.gov/info/accountants/stafficreporting.htm.

(n85)Footnote 85. See SEC Release No. 33-8762 (December 20, 2006), available at <http://www.sec.gov/rules/proposed/2006/33-8762.pdf>.

(n86)Footnote 86. SEC press release, December 13, 2006, available at <http://www.sec.gov/news/press/2006/2006-206.htm>.

(n87)Footnote 87. See SEC Press Release 2007-101 (May 23, 2007), available at <http://www.sec.gov/news/press/2007/2007-101.htm>.

(n88)Footnote 88. See PCAOB Auditing Standard No. 5 was approved by the SEC on July 27, 2007, <http://www.sec.gov/rules/pcaob/2007/34-56152.pdf>.

(n89)Footnote 89. See Gibson, Dunn & Crutcher, LLP, *SEC Issues Interpretive Guidance Regarding Section 404 Internal Controls and PCAOB Adopts Auditing Standard No. 5* (May 25, 2007).

(n90)Footnote 90. Gibson, Dunn & Crutcher, LLP, *SEC Issues Interpretive Guidance Regarding Section 404 Internal Controls and PCAOB Adopts Auditing Standard No. 5* (May 25, 2007).

(n91)Footnote 91. See SEC Release No. 3-8809 (June 20, 2007), available at <http://www.sec.gov/rules/final/2007/33-8809.pdf>.

(n92)Footnote 92. See SEC Release No. 33-8760 (December 15, 2006), available at <http://www.sec.gov/rules/final/2006/33-8760.pdf>.

(n93)Footnote 93. SEC Release No. 33-8760.

(n94)Footnote 94. See SEC Release No. 33-8934 (June 26, 2008), available at <http://www.sec.gov/rules/final/2008/33-8934.pdf>.

(n95)Footnote 95. See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 158 (September 2006), available at <http://www.fasb.org/pdf/fas158.pdf>.

(n96)Footnote 96. Hearing of House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Entities (March 12, 2009), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr031209.shtml.

(n97)Footnote 97. Financial Accounting Statement 157, Fair Value Measurements, available at <http://www.fasb.org/st/summary/stsum157.shtml>.

(n98)Footnote 98. Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, Pub. Aff. Rev. 10, 11 (2003), available at www.pac.org/pages/annual_report_2003.pdf.

(n99)Footnote 99. Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, Pub. Aff. Rev. 10, 11 (2003), available at www.pac.org/pages/annual_report_2003.pdf.

(n100)Footnote 100. See Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, Pub. Aff. Rev. 10, 12 (2003); Q&A With Ralph C. Ferrara, *The Rules Have Changed*, available at www.mckinsey.com/knowledge/featured/forum/PDF/mckinsey_risk_ferrara.pdf. See also *The Business Roundtable v. SEC*, 905 F.2d 406, 284 U.S. App. D.C. 301 (D.C. Cir. 1990); *Santa Fe Indus. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1997).

(n101)Footnote 101. See Section 2.09 *infra*.

(n102)Footnote 102. See Sarbanes-Oxley Act § 203, 15 U.S.C. § 78j (2003).

(n103)Footnote 103. See Sarbanes-Oxley Act § 302, 15 U.S.C. § 7241 (2003); Sarbanes-Oxley Act § 906, 18 U.S.C. § 1350 (2003). Prior to the Sarbanes-Oxley Act, many large companies voluntarily included declarations of management responsibility for financial statements in their annual reports to stockholders.

(n104)Footnote 104. See Regulation Analyst Certification, 17 CFR § 242; SEC Release No. 34-48252 (Jul. 29, 2003). A number of investment banking firms established voluntary codes on this subject in advance of the SEC's regulations.

(n105)Footnote 105. Sarbanes-Oxley Act § 201(A), 15 U.S.C. § 78j (2003). See Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, Pub. Aff. Rev. 10, 11 (2003).

(n106)Footnote 106. House Committee on Financial Services Report, *The Sarbanes-Oxley Act: The First Year*, 10 (2003) ("Corporate boards are changing in advance of the listing requirements of the exchanges. Many have already adopted the NYSE guidelines and changed board and audit committee structure accordingly."). As another example of corporate reforms, a Business Roundtable survey of the corporate governance practices of its members in March 2005, found the following: (1) 82 percent of Roundtable companies reported that their boards were at least 80 percent independent and 96 percent reported that at least 60 percent of their boards were independent; (2) 83 percent of Roundtable companies had an independent lead director, independent chairman or presiding outside director; (3) 100 percent of Roundtable companies reported that they expect their outside directors to meet in executive session at least once per year, and 71 percent expected to do so at every board meeting during 2005; and (4) 65 percent of all Roundtable companies encourage education programs for new or all directors while 43 percent require education programs for new directors. See Business Roundtable, *The Business Roundtable Corporate Governance Survey Key Findings*, March 2005, available at www.businessroundtable.org/taskforces/taskforce/document.aspx?qs=6926BF807822B0F1AD74F8122FB51711FCF539CFC3D3B3. "The voluntary acceptance of best practices, articulated by both investors and companies, has grown substantially over the past year." House Committee on Financial Services Report, *The Sarbanes-Oxley Act: The First Year*, 10 (2003) (citing Terry Gallagher, CEO of Corporate Governance Associates and former Vice President-Corporate Governance of Pfizer, Inc.).

(n107)Footnote 107. Though certainly steps in the right direction, we note that these voluntary changes should not be overvalued. In the words of Warren Buffett, "[t]he acid test for reform will be CEO compensation. Managers will cheerfully agree to board 'diversity,' attest to SEC filings and adopt meaningless proposals relating to process. What many will fight, however, is a hard look at their own pay and perks." Berkshire Hathaway Inc. 2002 Annual Report 18 (2003).

(n108)Footnote 108. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 743, 758 (codified at 15 U.S.C. 78u-4 (2003)).

(n109)Footnote 109. See *CalSTRS' Ethical Victory*, Financial Times Mandate (Aug. 25, 2003).

(n110)Footnote 110. See Ronna Abramson, *Settling for Reform*, TheStreet.com (Sept. 3, 2003).

(n111)Footnote 111. See Ronna Abramson, *Settling for Reform*, TheStreet.com (Sept. 3, 2003). For additional discussion of the Siebel settlement, see § 2.06[2] below.

(n112)Footnote 112. See Ronna Abramson, *Settling for Reform*, TheStreet.com (Sept. 3, 2003). For additional discussion of the Hanover settlement, see § 2.06[2] below.

(n113)Footnote 113. Stephen Taub, *Ashland Will Allow Investors to Nominate Directors*, Institutional Shareholder Services, The Friday Report (Feb. 4, 2005).

(n114)Footnote 114. See Tyson Foods, Inc. Form 8-K (filed on Jan. 18, 2008), available at <http://www.sec.gov/Archives/edgar/data/100493/000010049308000002/0000100493-08-000002-index.htm>.



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Corporate Governance: Law and Practice

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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.02

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§ 2.02 The Legal Landscape of Corporate Governance Reform

[1] The Delaware Judiciary's Stricter Scrutiny of Directors and Corporate Executives

Another source of corporate governance reform has been the Delaware state judiciary, considered the country's most experienced state judiciary in corporate law. The Delaware judiciary has become increasingly active in the corporate governance arena, no doubt motivated in part by a desire to maintain state primacy in corporate governance regulation. During the first half of 2003, Delaware judges spoke out in forums and articles, presenting the view that corporate wrongdoing should be stopped by heightened scrutiny of board decisions.ⁿ¹ These informal assertions foreshadowed an emerging trend in Delaware jurisprudence. The first half of 2003 was characterized by a string of victories for plaintiffs, as Delaware courts reversed decisions in favor of defendant directorsⁿ² and allowed derivative actions against directors to go forward.ⁿ³ By 2006, the trend toward stricter judicial scrutiny of directors' actions began to wane, as Delaware courts upheld judgments in favor of defendant directorsⁿ⁴ and refused to permit some derivative actions against directors to go forward.ⁿ⁵

In *In re Oracle Derivative Litigation* ⁿ⁶ the Delaware Chancery Court set a high bar for independence standards for members of special litigation committees, suggesting that a broader inquiry into director independence may be advisable as a general matter in cases where a conflict of interest may exist. Rejecting the directors' argument that the applicable standard for evaluating the independence of a special litigation committee was simply whether the members of the special litigation committee were under the "domination and control" of the defendant directors, the court looked to more subjective factors, including informal relationships between directors and corporate officers, and considered the appearance of a lack of independence created by such relationships, concluding that the applicable standard was whether the committee members were "*for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind."ⁿ⁷ The *Oracle* court found that the connections that the corporate officers whose conduct was being investigated and the members of the special litigation committee all had to Stanford University, as alumni, speakers, tenured faculty professors and major donors, were "so substantial that they cause[d] reasonable doubt about the [committee's] ability to [act] impartially."ⁿ⁸

In contrast, in *Beam v. Stewart* ⁿ⁹ the following year, the Delaware Supreme Court affirmed a lower court ruling dismissing a shareholder derivative action challenging the independence of the board of directors of Martha Stewart

Living Omnimedia. In *Beam*, the court rejected the shareholder's "structural bias" argument, which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking.¹⁰ In evaluating the directors' independence, the court stated that "[a]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."¹¹ Rather, in order to impair independence, the "relationship must be of a bias-producing nature."¹²

In *Krasner v. Moffett*,¹³ the Delaware Supreme Court reversed the dismissal of a shareholder class action, finding that the complaint adequately alleged that a majority of the directors recommending a merger of sister companies Freeport-McMoRan Sulphur, Inc. (FSC) and McMoRan Oil & Gas Co. (MOXY) to the shareholders had "disabling conflicts of interest."¹⁴ In *Krasner*, the plaintiff FSC shareholders alleged that three of the seven directors of FSC, who were also directors of MOXY, stood on both sides of the transaction and thus could not be considered disinterested and independent. The plaintiffs also alleged that two other FSC directors "had an interest in appeasing the MOXY and FSC insiders who also served with [them] on the boards of other [related] companies."¹⁵

Though the lower court found that the complaint alleged sufficient facts to infer that a majority of the board was interested in the merger, it held that "despite the presence of interested directors ... there are no facts from which one can infer that the interested directors interfered with the committee's deliberations or negotiations."¹⁶ As a result, the Court of Chancery determined that the complaint would be evaluated under the business judgment rule and dismissed the case. However, the Delaware Supreme Court reversed the decision below, concluding that "[b]ecause the plaintiffs have sufficiently alleged facts to suggest that the ... transaction was 'not approved by a majority consisting of disinterested directors,' the plaintiffs are entitled at the pleading stage to the inferences that may lead to the conclusion that the business judgment rule would not apply to the ... board's decision to approve ... the merger and to recommend it" to the stockholders.¹⁷

Cases such as *Oracle* and *Krasner* were described by commentators as decisions that "clearly signal a revolution in the Delaware judiciary's attitude toward boardroom conduct. The perceived leniency of the traditional business judgment rule is being redefined or bypassed by an emerging focus on new rubrics, such as whether the directors acted in good faith, were sufficiently disinterested and met the demands of enhanced scrutiny [T]he 'rules' determining proper board conduct are being changed by the Delaware courts to impose higher standards" on directors.¹⁸ For example, in the March 2007 *Netsmart* decision, Vice Chancellor Strine stated that, in the context of a company's sale, directors assume a fiduciary duty which changes the business judgment rule from a test of mere rationality to one of reasonableness, a "a more searching ... review [with] less tolerance for slack by the directors."¹⁹ "To paraphrase Dorothy's remarks on entering the Land of Oz, 'this sure doesn't look like Delaware anymore.'"²⁰

The options backdating scandal has resulted in further scrutiny of the actions of corporate boards. Stock options are generally set at the market price of the underlying stock on the date of grant. Backdating can have the effect of lowering option exercise prices to a more attractive pre-grant market price. This practice results in both accounting and tax irregularities for the companies that engage in backdating. Barnes & Noble, Apple, Family Dollar Stores and Sepracor are a few of the more than 80 companies that have been forced to restate their financials over 2006 and 2007 as a result of such option grant issues.²¹

Additionally, Chancellor Chandler of the Delaware Chancery Court issued two opinions on February 6, 2007, in which the court rejected the argument that companies are shielded from backdating complaints under the business judgment rule, possibly setting the stage for other options backdating suits. The two cases, *Ryan v. Gifford* and *In re Tyson Foods, Inc.*, are notable as the first in which a court has clearly come down on the side of plaintiffs alleging harm from options backdating. In the *Tyson Foods* opinion, Chancellor Chandler went so far as to state, "At their heart, all backdated options involved a fundamental, incontrovertible lie."²²

These developments do not, however, presage the repeal of the business judgment rule where the issue is one of the

duty of care rather than the duty of loyalty or conflict of interest issues. Importantly, on February 24, 2009 the Delaware Court of Chancery issued an opinion re-affirming the rule. In *In re Citigroup Inc. Derivative Litigation* ("*Citigroup*")ⁿ²³ the Court of Chancery addressed the liability of companies and their boards whose actions (or inactions) may be the prime target of litigation in light of the ongoing financial crisis. In *Citigroup*, the Court dismissed all but one claim in a shareholder derivative action seeking to recover against board members of Citigroup Inc. losses arising from exposure to the subprime lending market. Most noteworthy, the opinion made a clear statement that the business judgment rule continues to be the guiding standard by which to analyze whether directors have met their duty of care, even in light of the current financial crisis.

Plaintiffs, shareholders of Citigroup, brought the action against current and former directors and officers of the company alleging, among other things, that the defendants breached their duties by failing to properly monitor and manage the risks Citigroup faced from problems in the subprime lending market, even in the face of alleged "red flags". Plaintiffs' duty of care argument was based on a theory of director liability articulated in dicta in the 1996 *In re Caremark* decision.ⁿ²⁴ In a typical *Caremark* action, plaintiffs argue that the defendants are liable for damages arising from a failure to properly monitor or oversee employee misconduct or violations of law. Significantly, the Court ruled that the actions of the Citigroup defendants were not properly viewed as failures of oversight but rather as activities protected by the business judgment rule. The Court noted that plaintiffs' claims were based on defendants' alleged failure to properly monitor Citigroup's *business risk*, specifically its exposure to the subprime mortgage market, rather than, for example, an alleged oversight failure allowing widespread criminal activity. As the Court pointed out, plaintiffs were attempting to hold the director defendants personally liable for making business decisions that, in hindsight, turned out poorly for the company.

The Court made it clear that obligations to implement and monitor a system of oversight do not, absent extraordinary circumstances, eviscerate the core protections of the business judgment rule which are "designed to allow corporate managers and directors to pursue risky transactions without the spectre of being held personally liable if those decisions turn out poorly." As the Court further noted, Citigroup was in the business of taking on and managing investment and other business risk, and "[t]o impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk." The *Citigroup* decision reinforces the long-standing principle that, absent extraordinary circumstances, a Delaware Court will not second-guess the business decisions made by a well-informed board, and that no different standard will be, or need be, applied in light of current market conditions.

[2] Judicial Exploration of the Doctrine of "Good Faith"

It appears that the Delaware judiciary is also exploring the boundaries of directors' duty to act in good faith, a duty that has traditionally been held to be breached primarily in instances of self-dealing or breach of the duty of loyalty. Recently, allegations that directors were acting with a complete inattention to consequential details have been found sufficient to constitute a violation not only of their fiduciary duties to act with due care and loyalty, but also of their duty to act in *good faith*.ⁿ²⁵ It seems that the Delaware courts no longer intend to limit directors' personal monetary risk to the traditional breach of good faith situations where directors are personally benefiting from the transaction. Rather, commentators have suggested that "[f]ailing to consider publicly articulated and well established principles of good corporate governance could be considered by a court in determining whether the duty of care was met and, according to [then Chief Justice] Veasey, whether the directors acted in good faith when making their decision."ⁿ²⁶ Former Chief Justice Veasey responded that "[t]he concept of good faith has been in our jurisprudence and statutory law for a long time. It works as part of the ... business judgment rule ... and it is part of the directors' statutory oversight responsibility."ⁿ²⁷

[a] *In re The Walt Disney Company Derivative Litigation*

In *In re The Walt Disney Company Derivative Litigation*,ⁿ²⁸ shareholder plaintiffs filed a derivative action alleging that the board of directors breached its duty of care with respect to the hiring and subsequent no-fault termination of Michael Ovitz, the terms of both of which were negotiated almost exclusively by Disney's CEO (and close personal friend of Ovitz), Michael Eisner. Upon his no-fault termination, Ovitz received severance pay and other benefits totaling \$140 million. It was further alleged that the Disney board never sought to negotiate with Ovitz regarding his departure, did not consider whether to seek a termination based on fault and did not explore any alternatives.

In the motion to dismiss stage of this litigation, the court acknowledged its hesitation to second-guess the decisions of independent directors, holding that the complaint sufficiently alleged facts suggesting "that the Disney directors failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders."ⁿ²⁹ The court concluded that "[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct.' Thus, plaintiffs' allegations support claims that fall *outside* the liability waiver provided under Disney's certificate of incorporation."ⁿ³⁰

Following a thirty-seven day trial, the *Disney II* court ruled in August 2005 that the Disney defendants did not breach their fiduciary duties or commit waste.ⁿ³¹ The court noted that "Delaware law does not ... hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices," and where "decision-makers act as faithful servants ... [t]he redress for failures ... must come from the markets, through the actions of shareholders and the free flow of capital, and not from this Court."ⁿ³² On the apparent expansion of directors' duty of good faith, the *Disney II* court noted that, in the end, "it makes no difference whether the words 'fiduciary duty of' are placed in front of 'good faith' because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable [under Section 102(b)(7) of the Delaware General Corporation law] because they are disloyal to the corporation."ⁿ³³ In terms of the standard for determining whether directors have acted in good faith, the *Disney II* court stated that "the concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only one) standard."ⁿ³⁴

In June 2006, the Supreme Court of Delaware affirmed the Court of Chancery's holding in *Disney II* that the Disney defendants did not breach their fiduciary duties or commit waste.ⁿ³⁵ The Court explicitly approved of the good faith standard articulated in *Disney II* as "a legally appropriate, although not the exclusive, definition of fiduciary bad faith."ⁿ³⁶ The Supreme Court emphasized that proving bad faith is a high standard. In answering the question of "whether gross negligence (including a failure to inform one's self of available material facts), without more, can [] constitute bad faith," the court stated, "The answer is clearly no [G]rossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith."ⁿ³⁷ The Court further explained that conduct constituting a failure to act in good faith under the standard described in *Disney II* occurs "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."ⁿ³⁸ The Court stated that "such misconduct is properly treated as a non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith."ⁿ³⁹

The Delaware Chancery Court reiterated several principles espoused in the initial *Disney* decision in *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*.ⁿ⁴⁰ The plaintiffs asserted that the founder and Chief Executive Officer of the company breached his fiduciary duties of loyalty and good faith by obtaining compensation arrangements without regard to the company's best interests and by exerting improper influence on other board members who approved the compensation. The court, in ruling on a motion to dismiss, found that the plaintiffs' allegations, if true, could indicate that the CEO breached his fiduciary duties since he was under a duty to see that his own employment arrangements were negotiated "in an adversarial and arms-length manner."ⁿ⁴¹ In a nod to concerns over the welfare of the business judgment rule following the *Disney* decision, the *Integrated Health Services* court also indicated that "The court does not look at the reasonableness of a Board's action in this context [executive

compensation], as long as the Board exercised some business judgment."n42

The *Disney* and *Integrated Health Services* decisions are representative of the view that "good corporate governance mandates that directors proactively inform themselves about corporate developments and aggressively intervene to understand reported troublesome corporate behavior that is not voluntarily brought before the Board by management."n43 It is clear that corporate directors can no longer knowingly stick their heads in the sand to avoid addressing corporate issues without exposing themselves to potential liability for breach of the duty of good faith. Additionally, the *Disney* decision (as reiterated in the *Integrated Health* decision) provides a pointed warning that protections afforded by the business judgment rule and exculpatory charter provisions permitted by state law (which in Delaware and some other states have exceptions for acts or omissions not in good faith) will not encompass instances where directors "consciously and intentionally disregard [] their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."n44

[b] *In re Abbott Laboratories Derivative Shareholder Litigation*

Other derivative cases have demonstrated a similar "skepticism of board passivity and the same willingness to find a lack of good faith as Delaware cases have shown"n45 For example, in *In re Abbott Laboratories Derivative Shareholders Litigation* n46 the Seventh Circuit considered shareholder derivative plaintiffs' allegations that over a period of six years, Abbott directors failed to inquire into or even question management about known violations of Food and Drug Administration regulations (reported in the company's filings and in the press) that ultimately resulted in Abbott paying a fine of over \$100 million to the FDA. Similar to the holding in *Disney*, the court found that these claims, if true, "support a reasonable assumption that there was 'a sustained and systematic failure of the board to exercise oversight,' in this case intentional in that the directors knew of the violations of law, [and] took no steps in an effort to prevent or remedy the situation," which resulted in substantial corporate losses.n47 Assuming the truth of the allegations, the court held that the directors' failures were so egregious as to constitute a lack of good faith.n48 Accordingly, the plaintiffs were excused from making demand upon the corporation, and the directors were not entitled to the protections of exculpatory clauses permitted by the Illinois corporate law.n49

In *Disney* and *Abbott Labs.*, courts have held that the allegations of directors' affirmative failure to consider troubling corporate developments cast doubt on whether the directors acted in good faith, and consequently, were entitled to the protections of exculpatory charter provisions.n50

[c] *Stone v. Ritter*

In *Stone v. Ritter*, shareholders brought a derivative complaint against directors of AmSouth Bancorporation ("AmSouth") for failing to ensure that a Bank Secrecy Act compliance and reporting system existed, the lack of which, shareholders alleged, resulted in AmSouth paying \$50 million in fines and civil penalties.n51 The Court of Chancery dismissed the complaint for failure to adequately plead that a pre-suit demand would be futile.n52 In assessing whether pre-suit demand requirements are excused where the claim is based upon failure to exercise oversight, the plaintiff must allege facts that cast doubt on whether directors acted in good faith in exercising their oversight responsibilities.n53 In *Stone v. Ritter*, the Delaware Supreme Court adopted the *Caremark* standard for assessing bad faith in oversight liability cases.n54 In *Caremark*, the Delaware Court of Chancery recognized that "[g]enerally where a claim of directoral liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation ... only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability.n55 In *Stone v. Ritter*, the Supreme Court also held that the duty to act in good faith is not a separate duty, but rather is a subsumed within the duty of loyalty. Affirming the lower court's dismissal of the complaint, the Supreme Court held that "the failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,] i.e., a condition, 'of the fundamental duty of loyalty.'"n56

[d] Implications for Exculpation and Indemnification

Cases blurring the distinction between breaches of the duties of care and loyalty and breaches of the duty of good faith have introduced uncertainty as to the scope of protection offered by the business judgment rule and exculpatory provisions pursuant to Section 102(b)(7) of the Delaware General Corporation Law.ⁿ⁵⁷ As the concept of the director's obligation to act in good faith is given new breadth and content, it may well restrict a company's ability to indemnify its directors and officers. As a matter of state law in Delaware, directors and officers are not eligible for indemnification where their conduct was "not in good faith."ⁿ⁵⁸ Thus, the holdings in *Disney* and *Stone v. Ritter* raise the possibility (though not addressed by the court) that D&O insurance carriers may disclaim coverage where directors have not acted in good faith, "relying on the exclusions for willful or intentional misconduct and wrongful acts commonly found in recent [D&O] policies."ⁿ⁵⁹ If director inaction is no longer indemnifiable or protected by exculpatory clauses, it is likely that D&O coverage of this area will only be available, if at all, at a significantly increased premium. Thus, judicial exploration of the concept of "good faith" already has affected the accessibility of exculpatory provision protection in some states and has the potential to significantly impact the availability of indemnification and D&O coverage for directors and officers.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Governing Documents & Procedures

FOOTNOTES:

(n1)Footnote 1. For example, at a roundtable discussion sponsored by the Harvard Business Review in January 2003, Delaware Supreme Court Chief Justice E. Norman Veasey alluded to the need for heightened judicial review of director conduct. Chief Justice Veasey indicated that recent events have led to the development of a new set of expectations for directors and executives that is "changing how the courts look at these issues." *What's Wrong With Executive Compensation? A Roundtable Moderated by Charles Elson*, Harv. Bus. Rev., Jan. 2003, at 76. Additionally, in a keynote address to about 40 attendees at an institutional investor conference in early July 2003, Chief Justice Veasey stated that "[t]he courts should examine processes and examine them carefully. Directors should not just go along, as maybe they did years ago." Michael P. Bruno, *Delaware Chief Justice: It's About the Process*, Institutional Shareholder Services, The Friday Report, July 18, 2003.

(n2)Footnote 2. See, e.g., *Krasner v. Moffett*, 826 A.2d 277 (Del. 2003) ; *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) ; *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003) . "From mid-2002 to [February of 2003], the Delaware Supreme Court has issued a series of opinions in cases involving the performance by directors of their fiduciary duties. In every one of these recent cases, the Supreme Court held for the shareholders and against the directors." House Committee on Financial Services Report, *The Sarbanes-Oxley Act: The First Year* 13 (2003) (quoting Ira Millstein).

(n3)Footnote 3. See, e.g., *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) ; *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) . But see *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) .

(n4)Footnote 4. See, e.g., *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006) .

(n5)Footnote 5. See, e.g., *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) .

(n6)Footnote 6. *In re Oracle Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) .

(n7)Footnote 7. *Oracle*, 824 A.2d at 920 (emphasis added).

(n8)Footnote 8. *Oracle*, 824 A.2d at 942 "Persons of integrity and reputation can be compromised in their ability to act without bias when they must make a decision adverse to others with whom they share material affiliations."

Oracle, 824 A.2d at 947 .

(n9)Footnote 9. *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) .

(n10)Footnote 10. *Beam*, 845 A.2d at 1050-51 .

(n11)Footnote 11. *Beam*, 845 A.2d at 1050 .

(n12)Footnote 12. *Beam*, 845 A.2d at 1050 .

(n13)Footnote 13. *Krasner v. Moffett*, 826 A.2d 277 (Del. 2003) .

(n14)Footnote 14. *Krasner*, 826 A.2d at 279 .

(n15)Footnote 15. *Krasner*, 826 A.2d at 283 .

(n16)Footnote 16. *Krasner*, 826 A.2d at 282 (citing *In re Freeport-McMoRan Sulphur, Inc. S'holders Litig.*, CA No. 16729-NC (Del. Ch. Sept. 10, 2002) [bench ruling] at 41).

(n17)Footnote 17. *Krasner*, 826 A.2d at 284 .

(n18)Footnote 18. Charles M. Nathan, *The Beat Goes On*, *The Deal*, July 14, 2003 at 28.

(n19)Footnote 19. See *In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 192 (Del. Ch. 2007) .

(n20)Footnote 20. John C. Coffee Jr., *Post-Enron Jurisprudence*, 230 N.Y.L.J. 1, 5 (July 2003).

(n21)Footnote 21. See Ashby Jones, *Firms Settle Backdating Suits*, *Wall Street Journal*, November 19, 2007, at A15.

(n22)Footnote 22. See Paul J. Martinek, *Court Rulings Set Stage for Backdating Suits*, *Compliance Week*, February 21, 2007, available at http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3111.

(n23)Footnote 23. *In re Citigroup Inc. Derivative Litig.*, Civ. A. No. 3338-CC (Del. Ch. Feb. 24, 2009).

(n24)Footnote 24. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) .

(n25)Footnote 25. See, e.g., *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) ; *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) .

(n26)Footnote 26. Linda E. Rappaport et al., *Trends in Executive and Director Compensation Processes and Practices*, *Shearman & Sterling Client Update*, May 15, 2003.

(n27)Footnote 27. E. Norman Veasey, *A Perspective on Liability Risks to Directors*, *National Association of Corporate Directors, Directors Monthly*, Feb. 2005, Vol. 29, No. 2.

(n28)Footnote 28. *Disney*, 825 A.2d 275 (Del. Ch. 2003) .

(n29)Footnote 29. *Disney*, 825 A.2d at 277 .

(n30)Footnote 30. *Disney*, 825 A.2d at 290 .

(n31)Footnote 31. *In re Walt Disney Co. Derivative Litig.* 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) (unpublished)

("Disney II").

(n32)Footnote 32. *Disney II*, 2005 Del. Ch. LEXIS 113, at *4 & 7.

(n33)Footnote 33. *Disney II*, 2005 Del. Ch. LEXIS 113, at *177, n.463 .

(n34)Footnote 34. *Disney II*, 2005 Del. Ch. LEXIS 113, at *175 .

(n35)Footnote 35. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d (Del. 2006) ("Disney III").

(n36)Footnote 36. *Disney III*, 906 A.2d at 67 .

(n37)Footnote 37. *Disney III*, 906 A.2d at 64-65 .

(n38)Footnote 38. *Disney III*, 906 A.2d at 67 .

(n39)Footnote 39. *Disney III*, 906 A.2d at 66 .

(n40)Footnote 40. *Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins*, 2004 Del. Ch. LEXIS 122 (Aug. 24, 2004) .

(n41)Footnote 41. *Integrated Health*, 2004 Del. Ch. LEXIS 122, at *59 .

(n42)Footnote 42. *Integrated Health*, 2004 Del. Ch. LEXIS 122, at *52 .

(n43)Footnote 43. *Directors' Conscious Disregard of Known Risk Is Not Protected by Business Judgment Rule or Exculpatory Clauses*, Fried, Frank, Harris, Shriver & Jacobson LLP Client Update, July 2, 2003.

(n44)Footnote 44. *Disney*, 825 A.2d at 289 n.32 .

(n45)Footnote 45. John C. Coffee Jr., *Post-Enron Jurisprudence*, 230 N.Y.L.J. 1, 15 (July 2003).

(n46)Footnote 46. *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795 (7th Cir. 2003) .

(n47)Footnote 47. *Abbott Labs.*, 325 F.3d at 809 .

(n48)Footnote 48. *See Abbott Labs.*, 325 F.3d at 809 .

(n49)Footnote 49. *See Abbott Labs.*, 325 F.3d at 809 .

(n50)Footnote 50. Additionally, it is noteworthy that in two 2003 proceedings involving Chancellor Corporation's former officers and directors, the SEC effectively sought a federal scienter-based antifraud remedy for what amounted to an abdication of state law duties of care and, possibly, good faith. *See SEC Sues Former Top Officers, Directors and Auditors of Chancellor Corporation for Financial Fraud*, SEC Litigation Release No. 18104 (Apr. 24, 2003); *In the Matter of Michael Marchese*, SEC Release No. 34-47732 (Apr. 24, 2003). In these proceedings, one director was sued in an injunctive proceeding and another consented to an administrative settlement for violations of the antifraud provisions of the Securities Exchange Act of 1934 and for causing reporting violations by Chancellor. However, there was no claim that the former directors participated in the fraud themselves. Rather, the allegations were that the directors so neglected to make inquiry despite "red flags" indicating potential management fraud that they were "reckless" in their lack of due care when they signed SEC annual report filings. It appears that the SEC may be moving toward an expanded definition of recklessness as encompassing breaches of the duty of good faith.

(n51)Footnote 51. 911 A.2d 362, 364 (Del. 2006) .

(n52)Footnote 52. *911 A.2d at 364* .

(n53)Footnote 53. *911 A.2d at 367* .

(n54)Footnote 54. *911 A.2d at 369-70* .

(n55)Footnote 55. *911 A.2d at 364* .

(n56)Footnote 56. *911 A.2d at 369-70* , quoting *Guttman v. Huang*, *823 A.2d 492, 506 n.34 (Del. Ch. 2003)* .

(n57)Footnote 57. In pertinent part, Section 102(b)(7) of the DGCL provides that a certificate of incorporation may contain "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit" (emphasis supplied). A number of other states have a similar "good faith" exception from the liability limitation, but the Model Business Corporation Act, followed in a majority of states, does not.

(n58)Footnote 58. *Del. Code Ann. tit. 8, §§ 145(a) & (b) (2003)*.

(n59)Footnote 59. *Directors' Conscious Disregard of Known Risk Is Not Protected by Business Judgment Rule or Exculpatory Clauses*, Fried, Frank, Harris, Shriver & Jacobson LLP Client Update, July 2, 2003.



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Corporate Governance: Law and Practice

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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.03

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§ 2.03 Increasing Scrutiny of Compensation and Compensation Committee Practices

Though legislators, regulators and investors spent the first few years after the enactment of Sarbanes-Oxley focusing on commendable goals such as increasing the effectiveness of audit committees, increasing financial transparency and the accuracy of financial statements, the focus has shifted to management conduct as exemplified by executive compensation. In the words of Warren Buffett, the "acid test for [corporate governance] reform will be CEO compensation. Managers will cheerfully agree to board 'diversity,' attest to SEC filings and adopt meaningless proposals relating to process. What many will fight, however, is a hard look at their own pay and perks."¹ The scrutiny of executive compensation has grown even more intense in the wake of the recent financial crisis.

[1] Concerns About Executive Pay

Investors have little incentive to beleaguer management in good times. Appeased by high stock values and favorable returns, investors may turn a blind eye to director and executive compensation packages, even if exceedingly generous. Al Dunlap captured the dominant business philosophy during the 1990s: "The best bargain is an expensive CEO You cannot overpay a good CEO and you can't underpay a bad one. The bargain CEO is one who is unbelievably well compensated because he's creating wealth for the shareholders. If his compensation is not tied to the shareholders' returns, everyone's playing a fool's game."² During the booming 1990s, generous stock-option plans flourished, often providing top executives with option packages potentially worth tens of millions of dollars or more. However, investors who may have turned a blind eye to very generous executive pay packages in the 1990s have become less tolerant since the economy began to slump in 2000.³ This attitude is supported by a study showing "large, positive, unexplained bonus and option awards are predictive of both default and large rating downgrades."⁴

The focus of regulators and investors has increasingly turned to criticism of the oversize compensation packages of top executives who have not produced sizeable returns for shareholders.⁵ In July 2006, the SEC adopted sweeping changes to its rules relating to disclosure of executive and director compensation.⁶ In a press release announcing the new rules, then-SEC Chairman Christopher Cox stated his belief that the new rules "will help [shareholders and boards of directors] make better decisions about the appropriate amount to pay the men and women entrusted with running their companies."⁷ In July 2009, the SEC proposed further amendments to the rules relating to executive compensation to require additional disclosure.⁸ The SEC also recently proposed amendments to the proxy rules to provide for

advisory votes on executive compensation at companies that have received federal assistance under the Troubled Asset Relief Program, or TARP.ⁿ⁹

Shareholders are increasingly demanding a greater role in the compensation practices of the companies in which they invest. As of March 2009, RMG reported that it was tracking over 100 proposals requesting that shareholders be given the opportunity at each annual meeting to ratify the compensation of named executive officers set forth in the proxy statement through a non-binding vote.ⁿ¹⁰ This is in stark contrast to the single such proposal submitted to seven companies by the American Federation of State, County and Municipal Employees ("AFSCME") during the 2006 proxy season.ⁿ¹¹ These so-called "advisory vote" or "say on pay" proposals are modeled after the nonbinding shareholder advisory vote on board pay, a statutory requirement since 2002 at all publicly traded companies in the United Kingdom.ⁿ¹²

In addition, late in the 2009 proxy season, the United Brotherhood of Carpenters Pension Fund submitted to 20 companies a new shareholder proposal seeking a multi-pronged triennial vote on executive compensation, and a triennial forum between the compensation committee and shareholders to discuss executive compensation policies and practices.ⁿ¹³ The triennial vote on executive compensation would afford shareholders the opportunity to vote separately on the company's executive compensation practices, annual incentive plan, long-term incentive plan, and post-employment benefits. The Carpenters note the significant costs associated with a thorough compensation analysis and assert that a triennial vote "might improve the quality of the shareholder pay plan analysis and the informative value of the vote."ⁿ¹⁴ These proposals, as well as "traditional" say on pay shareholder proposals, will likely receive considerable attention in the 2009 proxy season.

At a Washington, DC summit in January 2007, Representative Frank, who chairs the House Financial Services Committee explained "We need to find some way to legislate greater shareholder involvement in setting CEO salaries."ⁿ¹⁵ In April of 2007, the U.S. House of Representatives overwhelmingly approved a bill introduced by Representative Frank, "The Shareholder Vote on Executive Compensation Act," that would have made an advisory vote on executive compensation mandatory at annual shareholder meetings occurring after 2008 for U.S. listed companies.ⁿ¹⁶ The bill similarly provided for a shareholder vote on golden parachute arrangements.ⁿ¹⁷ In April 2007, a companion bill was introduced in the Senate by Senator Barack Obama and a large number of cosponsors, but the Senate never acted on the bill.ⁿ¹⁸ On May 19, 2009, Senators Charles Schumer and Maria Cantwell introduced new corporate governance legislation entitled the "Shareholder *Bill of Rights* Act of 2009."ⁿ¹⁹ The legislation, among other things, would require all public companies to hold an annual advisory (non-binding) shareholder vote on executive compensation and would require public companies to obtain shareholder approval of any golden parachutes. A similar bill was introduced in the House of Representatives on June 12, 2009 by U.S. Representative Gary Peters. The bill, entitled the "Shareholder Empowerment Act of 2009,"ⁿ²⁰ would give shareholders an annual, non-binding advisory vote on senior executive compensation and would prohibit the board or compensation committee from entering into agreements providing for severance payments for executives terminated for poor performance.

In addition, on May 7, 2009, Senator Richard Durbin introduced two new pieces of legislation targeting "excessive compensation." The first bill, the "Excessive Pay Shareholder Approval Act," would limit the compensation for any single employee to no more than 100 times the average compensation for all employees unless that employee's compensation is approved by at least 60% of stockholders.ⁿ²¹ The second bill, the "Excessive Pay Capped Deduction Act of 2009," would amend the Internal Revenue Code to deny a deduction for "excessive compensation" paid to any employee, and would define "excessive compensation" as the amount by which an employee's compensation exceeds 100 times the average compensation for all company employees.ⁿ²²

Institutional investors also have increased their focus on executive compensation.ⁿ²³ For example, in 2005, many institutional investors focused on the executive compensation issues surrounding the departure of Phillip Purcell as Morgan Stanley CEO. Specifically, investors criticized Morgan Stanley for Purcell's \$44 million severance package despite Morgan Stanley's recent poor performance and guaranteed payments to other Morgan Stanley executives entered

into immediately before John Mack was appointed as Purcell's successor.ⁿ²⁴ More recently, American International Group ("AIG") became the subject of criticism when on June 15, 2008, the company announced its plans to replace Chief Executive Officer Martin Sullivan with Robert Willumstad, a director of the company who had been chairman since 2006, after the company posted losses for two consecutive quarters totaling \$13 billion. Mr. Sullivan received approximately \$47 million in severance and long-term compensation upon his departure from AIG.ⁿ²⁵ AIG faced criticism again in March 2009 for distributing \$165 million in bonus pay to its executives despite having received bailout funds from the federal government under the Troubled Asset Relief Program.ⁿ²⁶

Examples of situations where corporate directors have been accused of letting compensation spiral out of control abound.ⁿ²⁷ For instance, former AT&T Chairman Edward Whitacre Jr. received an estimated \$65 million (including options) in 2001, while the value of SBC stock dropped 18 percent.ⁿ²⁸ Former Walt Disney Co. CEO Michael Eisner averaged \$122 million in pay annually from 1997 through 2002, though shareholders received a *negative* 5 percent annual return over the same period.ⁿ²⁹ Mr. Eisner even received a \$5 million bonus in 2002 despite what critics said was lackluster performance by Disney stock.ⁿ³⁰ At Blockbuster Inc., CEO John F. Antioco's compensation increased 541 percent to \$56.8 million in 2004 while during the same period Blockbuster's operating income fell nearly 50 percent.ⁿ³¹ Pfizer, Inc., replaced its CEO, Henry McKinnell, in July 2006 after investors criticized his large retirement package and the company's poor stock performance.ⁿ³² Since McKinnell became CEO, Pfizer's shares had fallen 40 percent.ⁿ³³ Dr. McKinnell's retirement package, on the other hand, was valued at \$200 million, including deferred compensation he had earned over his more than 30 years with the company AND pension benefits with an estimated value of \$82.3 million.ⁿ³⁴ In January 2007, The Home Depot, Inc. CEO Robert Nardelli resigned amid controversy over his large compensation package and what some referred to as his "autocratic" management style.ⁿ³⁵ During his five years as CEO at Home Depot, Mr. Nardelli's compensation was valued at over \$245 million and the price of the company's stock dropped roughly 12 percent.ⁿ³⁶ Even Mr. Nardelli's resignation did not end the controversy over his compensation. Mr. Nardelli's generous separation agreement, which entitled him to a \$210 million severance package, based in large part on the contract entered into in 2000 when he was hired as CEO, prompted criticism from shareholders and others, including Congressman Barney Frank.ⁿ³⁷ The employment agreements for the new CEOs at Pfizer and Home Depot were significantly different from those of their predecessors. Mr. Nardelli was subsequently hired by private equity investors to lead a hoped for turnaround of Chrysler with a reported compensation package that was heavily weighted toward attainment of performance goals.ⁿ³⁸ With Chrysler's bankruptcy filing on April 30, 2009, Mr. Nardelli departed without reaping significant benefits from this package.

According to *Forbes*, CEO's at the 500 largest U.S. companies received a 38 percent increase in compensation during 2006 as compared to 2005, with an average compensation package of \$15.2 million.ⁿ³⁹ In fact, the ratio of chief executive pay to that of the average employee can be as high as 500-to-1, according to Bruce Hutton, a professor at the University of Colorado who conducted a private research project on executive compensation.ⁿ⁴⁰ Additionally, an annual Business Week study of executive compensation reported that average chief executive officer annual compensation increased 15 percent up to \$9.6 million in 2004, while the average worker's annual compensation increased 2.9 percent to \$33,176.ⁿ⁴¹ At an investor briefing in New York on June 11, 2002, Legg Mason Value Trust manager Bill Miller cited statistics indicating that CEO pay has increased 535 percent since 1990, far exceeding the 297 percent gain in the S&P 500 stock index, the 116 percent increase in corporate profits and the 32 percent rise in workers' pay.ⁿ⁴² "This is what has the average person up in arms," he said." John J. Castellani, President of Business Roundtable argues that "Executive compensation has closely followed the growth that companies have experienced in the last ten years."ⁿ⁴³ His views are supported by a 2006 study conducted by Frederic W. Cook & Co., Inc. and Mercer Human Resource Consulting for Business Roundtable,ⁿ⁴⁴ which concluded that between 1995 and 2005, the 9.6 percent growth in median total compensation of CEOs has closely tracked with the 9.9 percent median annual shareholder returns and 8.8 percent annual growth in market value of the 350 companies surveyed.ⁿ⁴⁵

The continued existence in a number of cases of what can be perceived as to be overly generous executive compensation packages is evidence that at least some corporate executives have yet to embrace governance reforms that affect their own pay and perks.ⁿ⁴⁶ Investor dismay at such practices will increase downward pressure on executive pay,

including bonuses, option grants and severance packages, in the future. One indication of this trend has been the surge in the number of shareholder proposals seeking to limit executive compensation and severance payments, reduce the number of options granted to executives and reduce pay disparity between a company's top executives and its lowest-paid workers.ⁿ⁴⁷ Furthermore, these proposals are receiving higher levels of support than ever before.ⁿ⁴⁸ Some executives have relinquished some or all of their compensation voluntarily, possibly to differentiate themselves from the pictures of executive excess.ⁿ⁴⁹ Additionally, Business Roundtable, an association of chief executive officers of prominent corporations, identified the concept of "pay for performance" as a fundamental characteristic of appropriate executive compensation programs.ⁿ⁵⁰ One commentator observed, "It is going to take some time before the whiff of illegal activities is dispelled from the arena of CEO pay."ⁿ⁵¹ Until then, companies can expect to feel continued pressure from the investment community to demonstrate their good faith by making cuts where it will be felt most--from their own paychecks.

[2] Changes to Compensation Committee Structure and Process

The role of the compensation committeeⁿ⁵² in determining compensation levels for the CEO and other executive officers varies among companies. Though some compensation committees meet regularly and meaningfully consider these decisions, others are less rigorous in their procedures. The practice of rubber-stamping management's recommendations has become less common, however, since the recent stock options backdating practices of many high profile companies came to light in early 2006 and the new SEC compensation rules were adopted in July of 2006. Since then, compensation committees have begun exercising increasing oversight over the issuance of option grants to ensure that proper practices are followed and that backdating does not occur.ⁿ⁵³

As media coverage of outrageous executive pay packages and compensation committee conflicts of interest increased awareness of compensation issues, it became clear that reform was needed in the area. In 2003, both the NYSE and NASDAQ adopted corporate governance listing standards requiring greater independence for directors tasked with compensation decisions and increased oversight of the decision making process.ⁿ⁵⁴ In the future it is likely that companies concerned with good governance, even if they are not subject to the NYSE or NASDAQ listing standards, will rely on a heightened definition of independence for compensation committee members so as to avoid even the appearance of cronyism or impropriety in decision making. In a January 2007 commentary, the Business Roundtable recommended that all directors "who sit on a compensation committee should be independent in both fact and appearance."ⁿ⁵⁵ Despite these positive reforms, questionable compensation practices continued at some companies during the sub-prime mortgage era. For example, when Angelo Mozilo, the CEO of Countrywide Financial Corp., did not agree with a compensation plan proposed by the compensation consultant hired by the company's compensation committee, he hired his own compensation consultant. The compensation committee approved the second firm's recommendation.ⁿ⁵⁶

The Aspen Institute Business Roundtable and the National Association of Corporate Directors ("NACD") Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee endorsed governance best practices that are likely to influence the design, implementation and oversight of future executive compensation programs in companies concerned with good governance.ⁿ⁵⁷ Well-advised companies may implement executive stock ownership and retention requirements to align executive compensation with the long-term interests of shareholders, as described by the Aspen Institute Business Roundtable and the NACD Commission, and are likely to avoid offering "excessive severance packages that reward executives who have not met performance goals and objectives during the term of their employment."ⁿ⁵⁸ It is also likely that companies will focus more attention on the establishment of "meaningful goals for performance-based compensation" that are linked to long-term shareholder value.ⁿ⁵⁹ Additionally, Business Roundtable and the NACD Commission recommended that companies consider a variety of performance metrics, both qualitative and quantitative, including performance relative to companies' peer groups, in setting performance measures, rather than measuring executive performance solely by the corporation's stock price or revenue.ⁿ⁶⁰ The post financial-crisis reform proposals included specifics about the design of pay plans--such as indexed or premium-priced options, clawbacks and bonus banking--and structural proposals regarding the independence

of compensation committees and an increased role for shareholder oversight.

In the future, well-advised companies will increasingly turn to the recommendations of independent compensation consultants and will take pains to follow a thorough and well-reasoned decision making process.ⁿ⁶¹ This is particularly important in light of the Delaware judiciary's demonstration of an increased sensitivity to shareholders' claims and heightened scrutiny of the fiduciary duties of good faith and due care.ⁿ⁶² After the Delaware decisions in *Disney* and *Integrated Health*, it is clear that compensation committees cannot fulfill the fiduciary duty of good faith by blindly rubber-stamping management recommendations.ⁿ⁶³ Selecting a compensation consultant to assist the compensation committee may not be as simple as it would seem, however. Companies must take care that their compensation consultants are and remain truly "independent." The independence of compensation consultants has increasingly come under Congressional scrutiny. In 2007, Congressman Henry Waxman, chairman of the House Committee on Oversight and Government Reform, sent letters to six compensation consultant firms requesting information about their relationship with their clients.ⁿ⁶⁴ In this judicial atmosphere, it is likely that shareholders increasingly will choose to litigate claims that compensation committees and boards did not act in good faith or committed corporate waste by approving excessive compensation or severance packages.

Additionally, it is likely that the common practice of benchmarking executive pay levels against those at peer companies will be subject to increased scrutiny. Over the years, benchmarking has tended to inflate executive compensation as companies compete to set executive pay levels within the top half or the top quarter of their peer group, as identified by consultant surveys. Such a decision is argued to be a sign of a healthy company with strong board support of its executives. However, the natural impact of such benchmarking is to ratchet up compensation to ever-higher levels, even without commensurate improvement in corporate performance. In the future, companies concerned with good governance will follow the NACD Commission's and Business Roundtable's recommendations to resist "an overreliance on surveys and other statistical analyses" and to rely on a variety of different sources, including company-specific factors, in determining executive compensation.ⁿ⁶⁵

While executive compensation in general continues to rise, some compensation committees are becoming more responsive to shareholder concerns. Prior to MBNA's 2006 merger with Bank of America, its compensation committee announced "that reductions in the levels of executive compensation would be appropriate."ⁿ⁶⁶ For example, total compensation at MBNA in 2004 was reduced by 34-37 percent, following 24-30 percent reductions in 2003. Further reductions are in the pipeline. These have included reductions in MBNA's base salary which will, eventually, affect retirement benefits. Furthermore, for the first time in 2004, performance restrictions were placed on MBNA restricted stock awards. Directors also are beginning to publicly express frustration over executive compensation. In July 2005, Cyberonics Inc. filed on Form 8-K an email from the chair of its compensation committee in which he resigned because "I unfortunately cannot support the direction of the governance practices of the Cyberonics board, in particular its practices regarding CEO compensation and succession."ⁿ⁶⁷ In a 2006 interview with Financial Times Jeffrey Immelt, chairman and chief executive of General Electric, urged companies to keep chief executive pay within a small multiple of that of their senior managers.ⁿ⁶⁸ Noting that his own pay was only two to three times that of his immediate subordinates, Immelt stated "The key relationship is the one between the CEO and the top 25 managers in the company because that is the key team. Should the CEO make five times, three times or twice what this group make? That is debatable, but 20 times is lunacy."ⁿ⁶⁹ Warren Buffet, in his 2007 letter to shareholders of Berkshire Hathaway, similarly expressed disapproval of some executives' salaries, deriding them as the result of "irrational and excessive [executive] comp practices."ⁿ⁷⁰

[3] Revisions to Executive Compensation Disclosure Requirements

In response to these widespread concerns regarding executive compensation, in July 2006 the SEC adopted revised executive compensation disclosure requirements.ⁿ⁷¹ The new rules require a Compensation Discussion and Analysis ("CD&A") of named executive officer compensation.ⁿ⁷² The CD&A must discuss the compensation awarded to, earned by, or paid to the named executive officers.ⁿ⁷³ This discussion is required to include, among other things, the

objectives of the company's compensation programs, each element of compensation, how the amount and formula for each element of compensation is calculated, and how each compensation element fits into the company's overall compensation objectives.ⁿ⁷⁴ The SEC is monitoring the quality of CD&A reports to ensure that the disclosures are adequate and that companies do not use "boilerplate" language and has sent comment letters requesting future improvements to several hundred companies.ⁿ⁷⁵ Under the new rules, most companies are required to include six tables disclosing various aspects of the named executive officers' compensation, including tables disclosing summary compensation, grants of plan-based awards, outstanding equity awards at year-end, option exercises and stock vested, pension benefits, and nonqualified deferred compensation.ⁿ⁷⁶ Significantly, companies are required to disclose the total compensation of the named executive officers under the new executive compensation requirements.ⁿ⁷⁷ Because such amounts must now be provided in the Summary Compensation Table, many boards of directors are taking a hard look at the how their executive compensation programs will be received by an increasingly critical external audience.

Moreover, as noted above, in July 2009 the SEC proposed amendments that, if adopted, will further revise the rules relating to executive compensation to require additional disclosure.ⁿ⁷⁸ In a speech to the Council of Institutional Investors on April 6, 2009, Chairman Schapiro questioned "whether our compensation disclosures accomplish the objective of providing shareholders with the most relevant information." She discussed recent studies that indicate the need to align compensation with prudent risk taking and said that the Commission is "considering whether greater disclosure is needed about how a company--and the company's board in particular--manages risk, both generally and in the context of setting compensation." In this regard, if adopted, the proposed amendments to the disclosure rules would require companies to discuss and analyze their overall compensation policies and practices for employees generally, including non-executive officers, if the risks arising from the incentives created by these policies and practices could have a material effect on the company as a whole. The proposed amendments also would require enhanced disclosure of potential conflicts of interests involving compensation consultants that provide advice to the board or compensation committee regarding executive or director compensation and also provide other services to the company.

[4] Executive Compensation Reforms in Response to the Financial Crisis

In October 2008, as part of a broader effort to help the economy recover from the collapse in the credit markets, Congress passed the *Emergency Economic Stabilization Act*, which gave the Treasury Department authority to purchase troubled assets from financial institutions under the Troubled Asset Relief Program ("TARP").ⁿ⁷⁹ Included in the legislation were certain executive compensation reforms for companies participating in TARP, including eliminating compensation programs for senior executive officers that encourage unnecessary and excessive risks, the recovery or "clawback" of any bonus or incentive compensation paid to a senior executive officer if the payment was based on materially inaccurate financial statements or other performance metric criteria, and a prohibition on "golden parachute" payments to senior executive officers.

Shortly after his inauguration, on February 4, 2009, President Barack Obama and Treasury Secretary Timothy Geithner held a press conference announcing new executive compensation guidelines for companies receiving TARP funds, and the Treasury Department issued a press release setting out those guidelines with a statement that further guidance would be issued in the near future.ⁿ⁸⁰ There are separate guidelines for companies that participate in any "generally available capital access program" and for those that need "exceptional assistance." For companies needing exceptional assistance, the guidelines limit the total compensation paid to senior executives to \$500,000 per year, other than payment in long-term restricted stock. In addition, these companies must fully disclose their senior executive compensation structure and strategy, including the rationale for how compensation is tied to sound risk management, and submit the compensation to a non-binding "say on pay" shareholder resolution. The guidelines also expand the group of executives subject to clawback restrictions to the next twenty senior executives, but add a culpability component for the non-senior executive officers, and expand the group of senior executives who are prohibited from receiving any severance payment from the senior executive officers to the company's top ten senior executives. Additionally, the next twenty-five senior executives are limited to a golden parachute of one year's compensation. Finally, a company's board of directors must adopt a company-wide policy on any "luxury expenditures" such as aviation services, renovations, entertainment and

holiday parties, and conferences and events.

Like companies receiving exceptional assistance, any participating company will be required to limit senior executive annual compensation to \$500,000 plus restricted stock unless the company discloses its compensation packages and, if requested, allows a non-binding "say on pay" shareholder resolution. Companies must review and disclose the reasons their compensation programs for both the senior executives and other employees do not encourage excessive and unnecessary risk taking. Thus, participating companies must expand both the scope of compensation arrangements they review (from only those affecting senior executive officers to those affecting potentially all employees) and the scope of the disclosure (from certifying that the arrangements do not encourage risk taking to explaining why the arrangements do not so encourage such behavior). In addition, the golden parachute limitation for the top five senior executives is lowered from no greater than three years' compensation to no greater than one year's compensation. The same policies on clawbacks and luxury expenditures that apply to companies receiving exceptional assistance would apply to all participating companies.

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Stimulus Act").ⁿ⁸¹ The Stimulus Act generally codifies the Treasury Department's guidelines on executive compensation with a few important differences. First, unlike the Treasury Department's guidelines, there is no mandatory cap on total compensation. Second, the standards generally apply equally to all TARP recipients. Third, the standards apply to all TARP recipients the most restrictive limitation on severance benefits--an absolute prohibition on any payment (other than accrued salaries and benefits) following departure of the senior executive officer and next five most highly compensated employees. Additionally, the Stimulus Act directs the Treasury Department to adopt implementing rules for these standards and also grants the Treasury Department the authority to establish additional standards.

Further guidance is expected to be issued soon. In testimony given before the Senate Banking Committee on May 20, 2009, Secretary Geithner stated the Treasury Department is in the process of preparing an Interim Final rule to implement the executive compensation and corporate governance provisions of the Stimulus Act.ⁿ⁸² Moreover, the Wall Street Journal reported on May 13, 2009 that "the Obama administration has begun serious talks about how it can change compensation practices across the financial-services industry, including at companies that did not receive federal bailout money."ⁿ⁸³ The initiative is "part of an ambitious and likely controversial effort to broadly address the way financial companies pay employees and executives, including an attempt to more closely align pay with long-term performance." The administration is also discussing "issuing 'best practices' to guide firms in structuring pay." On June 10, 2009, Secretary Geithner issued a statement outlining a set of five broad-based principles for executive compensation.ⁿ⁸⁴ Specifically, the principles state: (1) compensation plans should properly measure and reward performance; (2) compensation should be structured to account for the time horizon of risks; (3) compensation practices should be aligned with sound risk management; (4) we should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders, and; (5) we should promote transparency and accountability in the process of setting executive compensation.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Directors & Officers Compensation

FOOTNOTES:

(n1)Footnote 1. Berkshire Hathaway Inc. 2002 Annual Report 18 (2003). For further discussion of compensation committee and executive compensation issues, *see* Chapters 10, 15 and 16 *below*.

(n2)Footnote 2. *What's Wrong With Executive Compensation? A Roundtable Moderated by Charles Elson*, Harv. Bus. Rev. Jan. 2003, at 69 (*citing* Albert J. Dunlap, *Mean Business: How I Save Bad Companies and Make Good*

Companies Great (Andrew Wylie, Simon & Schuster 1997)).

(n3)Footnote 3. *See Executive Compensation Survey: A Wealth of Options*, Philadelphia Inquirer, June 1, 2003 (quoting Shannon Reid, a portfolio manager at Wachovia Corp.'s Evergreen Investments, one of the nation's largest mutual-fund groups, on excessive executive compensation: "It's given a lot more attention in bear markets than in bull markets ... Investors are a lot more forgiving when they're making money.").

(n4)Footnote 4. Phyllis Plitch, *Moody's Finds Link Between High Pay and Credit Risk*, Dow Jones Newswire (July 25, 2005). The Moody's study defined "unexplained" awards as "those that deviate substantially from expected pay based on a company's size, past performance and other variables."

(n5)Footnote 5. *See, e.g.*, Gretchen Morgenson, *Big Bonuses Still Flow, Even if Bosses Miss Goals*, N.Y. Times, June 1, 2006, at A1. Eric Roiter, former general counsel at Fidelity Management & Research Co., the investment arm of the Fidelity Investments mutual-fund company, stated, "We're concerned about grossly excessive CEO compensation." Aaron Lucchetti, *A Mutual-Fund Giant is Stalking Excessive Pay*, Wall St. J., June 12, 2002, at C1. In a recent commentary, the Business Roundtable stated, "[T]here has been a growing concern among investors and the public, that pay has not always been commensurate with performance, with a perception that some executives have reaped substantial financial rewards even at times of declining stock prices and large losses to employees and shareholders." Business Roundtable, *Executive Compensation: Principles and Commentary* 3 (Jan. 2007), reproduced in Appendix 15-A below .

(n6)Footnote 6. *See* SEC Release No. 33-8732A (August 29, 2006), available at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>. For further discussion of this topic, *see* § 2.03[3] and § 2.03[4].

(n7)Footnote 7. SEC press release, July 26, 2006, available at <http://www.sec.gov/news/press/2006/2006-123.htm>.

(n8)Footnote 8. *See* Proxy Disclosure and Solicitation Enhancements (July 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.

(n9)Footnote 9. *See* Shareholder Approval of Executive Compensation of TARP Recipients (July 1, 2009), available at <http://www.sec.gov/rules/proposed/2009/34-60218.pdf>. *See* Section 2.03[4] *infra* for further discussion of the TARP program.

(n10)Footnote 10. *See* Carol Bowie and Valerie Ho, RiskMetrics Group, *Proxy Season Guide to Executive Pay Issues*, Mar. 2009.

(n11)Footnote 11. *See Labor Funds to Sharpen Focus on Compensation in 2006*, IRRC Weekly Report, Dec. 16, 2005.

(n12)Footnote 12. *See* The Directors' Remuneration Report Regulations, 2002, S.I. 2002/1986 (U.K.); *see also Improving Pay Practices*, RMG International Research Analysts, Sept. 18, 2006, available at <http://blog.issproxy.com/2006/09/000152print.html>; *Labor Funds to Sharpen Focus on Compensation in 2006*, IRRC Weekly Report, Dec. 16, 2005; Rosanna Landis Weaver, *2007 Preview: Executive Pay*, ISS Governance Weekly, Jan. 19, 2007, available at <http://www.issproxy.com/governance/publications/2007archived/010.jsp>.

(n13)Footnote 13. RiskMetrics Group, *Carpenters File New "Triennial" Vote Proposal at P&G*, Risk & Governance Weekly (May 8, 2009); *Carpenters Target Pay at Procter & Gamble and 19 Others*, IR Magazine (May 13, 2009), available at http://www.shareholderforum.com/sop/Library/20090513_IRMagazine.htm.

(n14)Footnote 14. RiskMetrics Group, *Carpenters File New "Triennial" Vote Proposal at P&G*, Risk & Governance Weekly (May 8, 2009).

(n15)Footnote 15. See Kevin Drawbaugh, *Rep. Frank: CEO Pay Vote Bill by Mid-'07*, Reuters, Jan. 11, 2007.

(n16)Footnote 16. See House Financial Services Committee, *House Passes Executive Compensation Reform* (April 20, 2007), available at http://www.house.gov/apps/list/press/financialsvcs_dem/press042007.shtml.

(n17)Footnote 17. See H.R. 1257: Shareholder Vote on Executive Compensation Act, available at <http://www.govtrack.us/congress/billtext.xpd?bill=h110-1257>.

(n18)Footnote 18. See S. 1181: Shareholder Vote on Executive Compensation Act, available at <http://www.govtrack.us/congress/bill.xpd?bill=s110-1181>.

(n19)Footnote 19. See Shareholder Bill of Rights Act of 2009, available at <http://thomas.loc.gov/cgi-bin/bdquery/D?d111:36:./temp/bdtJ5y:./bss/d111query.html>.

(n20)Footnote 20. See Shareholder Empowerment Act of 2009, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2861ih.txt.pdf.

(N21)Footnote 21. See Excessive Pay Shareholder Approval Act, S.R. 1006, 111th Cong. (2009).

(n22)Footnote 22. See Excessive Pay Capped Deduction Act of 2009, S.R. 1007, 111th Cong. (2009).

(n23)Footnote 23. Nearly nine in 10 institutional investors recently indicated "the level of executive compensation is important or very important when evaluating a company." *Institutional investors wrestle with executive compensation*, Investment News, Vol. 9, Issue 15 (Apr. 18, 2005) (based on a survey of 100 pension funds, money managers and hedge funds conducted by Pensions & Investments magazine and Vivient Consulting LLC).

(n24)Footnote 24. See *Lex: Morgan Stanley*, Financial Times UK (July 9, 2005). As a result, Mack recently told Morgan Stanley that his own compensation would be based entirely upon performance. See *Lex: Morgan Stanley*, FT.com (July 8, 2005).

(n25)Footnote 25. See Hugh Son and Erik Holm, *AIG's Chief Willumstad May Earn \$22 Million a Year*, Bloomberg Press (July 18, 2008), available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=a1FGWqvJHYzo&refer=home>.

(n26)Footnote 26. See Adam Zagorin and Michael Weisskopf, *Obama's Challenge: Containing the AIG Bonus Outrage*, Time (Mar. 16, 2009), available at <http://www.time.com/time/politics/article/0,8599,1885561,00.html>.

(n27)Footnote 27. "While some compensation policy changes disclosed in the 2003 proxy season demonstrate that boards are aware that changes must be made, there are still many examples of poor practices that should be unthinkable in the wake of the scandals in 2002. These include option repricings, option exchanges, discretionary bonuses, lowering performance targets, and a whole range of stealth payments such as enhanced retirement benefits, consultancy agreements, gifts of restricted stock, and continued excessive severance payments." Paul Hodgson, *What Really Happened to CEO Pay in 2002: A Survey of Executive Compensation*, The Corporate Library (June 2003).

(n28)Footnote 28. SEC has since charged its name and Mr. Whitacre has retired. "An SBC spokesman said SBC stock has outperformed its telecom peers during Mr. Whitacre's 12-year tenure as head of the company, and he adds that 'a whole host of CEOs made a lot more' than Mr. Whitacre." Aaron Lucchetti, *A Mutual-Fund Giant is Stalking Excessive Pay*, Wall St. J., June 12, 2002, at C1.

(n29)Footnote 29. See Stewart Pinkerton, *Reforming the Boardroom: Seven Ways to Solve the Executive Pay Mess*, Forbes.com, July 23, 2003, at www.forbes.com/2003/07/23/cz_sp_0722execpay.html.

(n30)Footnote 30. See Stewart Pinkerton, *Reforming the Boardroom: Seven Ways to Solve the Executive Pay Mess*,

Forbes.com, July 23, 2003, at www.forbes.com/2003/07/23/cz_sp_0722execpay.html.

(n31)Footnote 31. See Louis Lavelle, et al, *A Payday for Performance*, Bus. Wk., Apr. 18, 2005 at 78. Business Week's survey was conducted with Standard & Poor's ExecuComp database.

(n32)Footnote 32. See *Pfizer Replaces CEO Targeted by Critics*, L.A. Times (July 29, 2006).

(n33)Footnote 33. See *Pfizer Replaces CEO Targeted by Critics*, L.A. Times (July 29, 2006).

(n34)Footnote 34. See Scott Hensley, *Payout for Former Pfizer Chief is Valued at Nearly \$200 Million*, Wall Street Journal, B5 (Dec. 22, 2006).

(n35)Footnote 35. See Ann Zimmerman, *Nardelli Leaves Home Depot, Will Get \$210M*, Dow Jones Newswire (Jan. 3, 2007). At the company's 2006 annual meeting, shareholders who wanted to address management were limited to one minute each, and none of the other directors attended the meeting, at the request of Mr. Nardelli.

(n36)Footnote 36. See Ann Zimmerman, *Nardelli Leaves Home Depot, Will Get \$210M*, Dow Jones Newswire (Jan. 3, 2007).

(n37)Footnote 37. See Parija B. Kavilanz, *Nardelli Out at Home Depot*, CNNMoney.com (Jan. 3, 2007); Ann Zimmerman, *Nardelli Leaves Home Depot, Will Get \$210M*, Dow Jones Newswire (Jan. 3, 2007).

(n38)Footnote 38. See Sholnn Freeman, *Home Depot's Ex-Chief to Lead Chrysler*, Washington Post, August 6, 2007, at A08.

(n39)Footnote 39. See Scott DeCarlo, *Big Paychecks*, Forbes, May 3, 2007, available at http://www.forbes.com/2007/05/03/ceo-executive-compensation-lead-07ceo-cx_sd_0503ceocompensationintro.html.

(n40)Footnote 40. See Jerry Useem, *Have They No Shame?*, Fortune, Apr. 28, 2003, at 56.

(n41)Footnote 41. See Louis Lavelle, et al, *A Payday for Performance*, Bus. Wk., Apr. 18, 2005 at 78. Business Week's survey was conducted with Standard & Poor's ExecuComp database.

(n42)Footnote 42. See Aaron Lucchetti, *A Mutual-Fund Giant is Stalking Excessive Pay*, Wall St. J., June 12, 2002, at C1.

(n43)Footnote 43. Business Roundtable press release, July 5, 2006.

(n44)Footnote 44. Frederic W. Cook & Co., Inc., *Research on CEO Compensation for Business Roundtable*.

(n45)Footnote 45. Aaron Lucchetti, *A Mutual-Fund Giant is Stalking Excessive Pay*, Wall St. J., June 12, 2002, at C1.

(n46)Footnote 46. In Berkshire Hathaway Inc.'s 2002 Annual Report, Warren Buffett called for directors to "stop such piracy It would be a travesty if the bloated pay of recent years became a baseline for future compensation. Compensation committees should go back to the drawing board." Berkshire Hathaway Inc. 2002 Annual Report (2003).

(n47)Footnote 47. See § 2.01[2] above.

(n48)Footnote 48. See § 2.01[2] above.

(n49)Footnote 49. For instance, John Mackey, chairman, CEO and founder of Whole Foods Market, announced in a letter to employees that his salary and total cash compensation would be no more than \$1 for 2007. See Letter from John Mackey to All Team Members (November 2, 2006), available at

http://www.wholefoodsmarket.com/blogs/jm/archives/2006/11/compensation_at_1.html. John Antioco, chairman and CEO of Blockbuster, also agreed to accept less compensation in 2006 than his contract entitled him to, after Blockbuster's performance foundered. *See*, Martha Graybrow, *Blockbuster CEO pay cut may make waves: experts*, available at, <http://www.reuters.com/article/ousivMolt/idUSN2037783520070320>. Similarly, Sidney Taurel, Eli Lilly's Chairman and CEO, did not receive a bonus for 2002 and voluntarily cut his salary to \$1 after profits dipped from the company's lapse on its exclusive patent on Prozac. *See* Joann Lublin, *Compensation Changes Hit CEOs Where It Hurts*, Wall Street Journal Online; Bill Hornaday, *Big bonuses don't reflect big profits*, *IndyStar* (June 15, 2003), available at www.indystar.com/articles/1/050945-8721-031.html. Along the same lines, former Delta Air Lines CEO Leo Mullin accepted a 10 percent reduction in pay. *See* Russell Grantham, *Delta chief fights furor, docks pay*, *Atlanta Journal-Constitution*, Apr. 4, 2003, available at www.ajc.com/business/content/business/delta/0403/04mullin.html.

(n50)Footnote 50. *See* Business Roundtable, *Executive Compensation: Principles and Commentary 1* (January 2007), reproduced in Appendix 15-A to Chapter 15 *below*, available at <http://64.203.97.43/pdf/ExecutiveCompensationPrinciples.pdf>.

(n51)Footnote 51. Paul Hodgson, *What Really Happened to CEO Pay in 2002: A Survey of CEO Compensation*, *The Corporate Library* (June 2003) (a survey based on a sample of the top 1,708 U.S. companies, as determined by market capitalization).

(n52)Footnote 52. *See* Chapter 10 *below*, discussing the compensation committee.

(n53)Footnote 53. *See* Karen Kennard and Troy Sauro, *Take Stock of Your Option Practices: SEC Chief Accountant Releases Important Guidelines on Stock Option Grants*, *Bingham McCutchen Securities Litigation Alert*, Oct., 2006.

(n54)Footnote 54. On April 4, 2003, the NYSE proposed rules requiring that compensation committees of listed companies be composed entirely of "independent directors" and meet other minimum standards. On February 26, 2003, NASDAQ proposed rules relating to the role of independent directors in making compensation-related decisions. On November 4, 2003, these proposals were approved by the SEC, with some changes. *See* SEC Release No. 34-48745, *NASD and NYSE Rulemaking: Relating to Corporate Governance* (Nov. 4, 2003). *See* § 10.05[1] *below* discussing independence requirements for compensation committee members.

(n55)Footnote 55. Business Roundtable, *Executive Compensation: Principles and Commentary 2* (January 2007) ("Committee members should have, and be perceived to have, the ability to exercise independent judgment free from any relationship or influence that could appear to compromise their ability to approach compensation issues decisively and independently").

(n56)Footnote 56. Greg Farrell, *Fight Over Countrywide CEO's Pay Show's Board's Role*, *USA Today* (Apr. 10, 2008), available at http://www.usatoday.com/money/companies/management/2008-04-09-ceo-pay-countrywide--mozilo_N.htm.

(n57)Footnote 57. *See* The Aspen Institute, *Long-Term Value Creation: Guiding Principles for Corporations and Investors* (June 2007); Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee (2003); Business Roundtable, *Executive Compensation: Principles and Commentary 3-4* (January 2007), reproduced in Appendix 15-A *below*; *see also Interim Report*, Committee on Capital Markets Regulations (November 30, 2006), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. ("We conclude there is a danger that the United States ... is falling behind best practices in shareholder rights. Because the market for corporate control is of central importance to the health of a capital market, shareholders should be given [greater voice].").

(n58)Footnote 58. Business Roundtable, *Executive Compensation: Principles and Commentary 3* (January 2007). *See also* Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation

Committee 26-28 (2003).

(n59)Footnote 59. Business Roundtable, *Executive Compensation: Principles and Commentary 1* (January 2007). *See also* Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 24-25 (2003).

(n60)Footnote 60. *See* Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 24-25 (2003). The Business Roundtable suggests that the following metrics, among others, can be used to measure executive performance: revenue and profit growth, net income, cash flow and cash management, market share, leadership, succession planning, workforce diversity and turnover, product quality and the promotion of a culture of integrity. *See* Business Roundtable, *Executive Compensation: Principles and Commentary 6* (Nov. 2003). Additionally, the NACD Commission advised that companies "[h]onor agreed-upon performance metrics; except under circumstances carefully weighed by the [compensation] committee, [companies should] not change performance metrics after the fact in order to provide additional compensation despite failure to achieve stated objectives." Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 25 (2003).

(n61)Footnote 61. *See* Business Roundtable, *Executive Compensation: Principles and Commentary 5* (January 2007) ("The compensation committee should have the authority to retain compensation consultants, and counsel expert in compensation matters, to provide the committee with independent advice in performing its responsibilities."). *See also* Joann S. Lublin, *Panel Proposes Ways to Constrain Executive Pay*, Wall St. J., Dec. 11, 2003, at A6 ("The [NACD] commission's proposed changes for compensation consultants suggest that a consultant retained and reporting directly to a board pay committee 'should not be retained by the company in any other capacity.'"). The NACD Commission also recommended that "[t]o avoid 'dueling consultants,' any consultant hired by management should not be engaged in assignments involving CEO or senior executive pay." Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 18-19 (2003).

(n62)Footnote 62. For further discussion, *see* § 2.02 *above*.

(n63)Footnote 63. For further discussion, *see* § 2.02[2] *above*.

(n64)Footnote 64. Gretchen Morgenson, *Panel to Look at Conflicts in Consulting*, New York Times, May 11, 2007, available at http://www.nytimes.com/2007/05/11/business/11pay.html?_r=2&oref=slogin&oref=slogin.

(n65)Footnote 65. Business Roundtable, *Executive Compensation: Principles and Commentary 10* (January 2007). *See also* Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 24 (2003) ("The [compensation] committee should oversee selection of the peer group against which the company's performance is to be measured, and have a clear understanding of the survey methodology used by their consultant. When judging peer companies for appropriateness, committees should use multiple criteria (such as number of employees, market value, and revenues), not just revenues alone.").

(n66)Footnote 66. Compensation Committee Report, MBNA, 2005 Proxy Statement, filed with the SEC on March 15, 2005.

(n67)Footnote 67. Form 8-K, Cyberonics, Inc., filed July 28, 2005 available at www.sec.gov/Archives/edgar/data/864683/000095012905007403/h27397e8vk.htm.

(n68)Footnote 68. Francesco Guerrera and Chrystia Freeland, *Immelt Wades Into Debate Over Executive Pay*, Financial Times, Nov. 3, 2006.

(n69)Footnote 69. Francesco Guerrera and Chrystia Freeland, *Immelt Wades Into Debate Over Executive Pay*, Financial Times, Nov. 3, 2006.

(n70)Footnote 70. Letter from Warren Buffet to Shareholders of Berkshire Hathaway, Inc. (February 28, 2007), *available at* <http://www.berkshirehathaway.com/letters/2006ltr.pdf>.

(n71)Footnote 71. *See* SEC Release No. 33-8732A (August 29, 2006), *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

(n72)Footnote 72. *See SEC Adopts Amendments to Executive Compensation and Related-Party Disclosure Rules*, Gibson, Dunn & Crutcher LLP Client Alert, July 26, 2006, *available at* <http://www.gibsondunn.com/practices/publications/detail/id/766/?pubItemId=8145>.

(n73)Footnote 73. *See* SEC Release No. 33-8732A (August 29, 2006), *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

(n74)Footnote 74. *See* SEC Release No. 33-8732A (August 29, 2006), *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

(n75)Footnote 75. *See* Staff Observations in the Review of Executive Compensation Disclosure (October 9, 2007), *available at* <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>; *see also* John White, "Where's the Analysis?," speech at Tackling Your 2008 Compensation Disclosures: The 2nd Annual Proxy Disclosure Conference (October 9, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch100907jww.htm>.

(n76)Footnote 76. *See* SEC Release No. 33-8732A (August 29, 2006), *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

(n77)Footnote 77. *See* SEC Release No. 33-8732A (August 29, 2006), *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

(n78)Footnote 78. Proxy Disclosure and Solicitation Enhancements (July 10, 2009), *available at* <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.

(n79)Footnote 79. Emergency Economic Stabilization Act of 2008, *available at* [http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR1424](http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR1424;); Troubled Asset Relief Program, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-110publ343/content-detail.html>.

(n80)Footnote 80. Press Release, U.S. Department of the Treasury, Treasury Announces New Restrictions on Executive Compensation (February 4, 2009), *available at* <http://www.treasury.gov/press/releases/tg15.htm>.

(n81)Footnote 81. H.R. 1, Division B, Title VII, § 7001 *et seq.*

(n82)Footnote 82. *See* Treasury Department press release, May 20, 2009, *available at* <http://www.ustreas.gov/press/releases/tg139.htm>.

(n83)Footnote 83. Deborah Solomon and Damian Paletta, *U.S. Eyes Bank Pay Overhaul*, Wall Street Journal, A1 (May 13, 2009).

(n84)Footnote 84. *See* Treasury Department press release, June 10, 2009, *available at* <http://www.ustreas.gov/press/releases/tg163.htm>.



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Corporate Governance: Law and Practice

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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.04

AUTHOR: Nell Minow John F. Olson

§ 2.04 Technological Advances Will Continue to Encourage Shareholder Activism

The key role of directors as the primary monitors of management in corporate governance of the 20th century was posited on the inability of shareholders to discuss and evaluate detailed information on corporate performance and to find and communicate with each other without incurring great expense.ⁿ¹ This basic premise may be changing in response to technological advances. The internet and the increased availability of electronic communication have provided widely accessible means for both low-cost access to information and easier direct communication among beneficial owners. For example, in July 2007, the SEC adopted new rules designed to facilitate the use of the internet to deliver proxy materials to shareholders.ⁿ² Under the so-called e-proxy rules, a company must post its proxy materials on a website and mail a notice to shareholders informing them of the availability of the proxy materials and how to access them.ⁿ³ According to John W. White, then-Director of the SEC's Division of Corporation Finance, the proposed rules are designed "to decrease substantially the costs incurred by issuers and others soliciting proxies while safeguarding the interests of investors."ⁿ⁴

In the past, directors of underperforming companies generally felt pressure only from large, well-funded institutional investors. Today, the internet has democratized the system, giving individual investors a louder voice by facilitating collective investor action. For example, shareholder activist Eric Jackson was credited with removing both Terry Semel, CEO of Yahoo, and Ed Zander, CEO of Motorola, in 2007 through internet-based campaigns.ⁿ⁵ Furthermore, a 2005 shareholder campaign by email and the internet contributed to shareholders of Alaska Air Group withholding approximately 42 percent of the vote from management's nominees, passing two binding mandatory bylaw shareholder proposals by the required supermajority votes and passing two other shareholder proposals.ⁿ⁶ In 1999, a group of irate shareholders of United Companies Financial Corp., a high-risk lender, "met" on an internet discussion board and discovered that they collectively controlled 40 percent of the company.ⁿ⁷ Through this cyberspace relationship, the group was able to deliberate and reach a consensus on what action to take, posting over 6,000 messages in the process.ⁿ⁸ When the company went into bankruptcy, the group successfully acquired a position normally reserved for large creditors, essentially becoming the equity committee.ⁿ⁹ The same year, disgruntled shareholders of Luby's Inc., a food-services company, organized on an internet message board and presented a low-budget slate of dissident candidates to challenge the incumbent directors.ⁿ¹⁰ Although traditionally the prohibitive cost of conducting a proxy fight has limited its availability to large institutional investors with sufficient resources and a considerable interest at stake, the shareholders group at Luby's managed to wage an on-line proxy battle for \$15,000, a comparative bargain.ⁿ¹¹

Though the shareholders' slate ultimately was not elected, the campaign itself was enough to spark significant corporate changes, among them the abrupt resignation of Luby's unpopular CEO. Companies can expect the continuation of internet-based shareholder activism in the future.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Shareholders Actions Against Corporations Business & Corporate Law Corporations Shareholders Meetings & Voting

FOOTNOTES:

(n1)Footnote 1. *See* Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, Pub. Aff. Rev. 10 (2003), available at www.pac.org/pages/annual_report_2003.pdf.

(n2)Footnote 2. *See* SEC Release No. 34-56135 (July 26, 2007), available at <http://www.sec.gov/rules/final/2007/34-56135.pdf>.

(n3)Footnote 3. SEC Release No. 34-56135.

(n4)Footnote 4. SEC press release, December 13, 2006, available at <http://www.sec.gov/news/press/2006/2006-209.htm>.

(n5)Footnote 5. *See* Anna Marie Kucek, *Motorola's Zander says it's time to resign*, Chicago Daily Herald (November 30, 2007) available at <http://www.dailyherald.com/story/?id=87087>.

(n6)Footnote 6. Press release, The Ownership Union, *A Shareholder Tsunami*, available at www.csrwire.com/article.cgi/4003.html.

(n7)Footnote 7. *See* Remarks by Commissioner Laura S. Unger at the American Society of Corporate Secretaries, *Dealing with the Wired Investor* (June 25, 1999) at www.sec.gov/news/speech/speecharchive/1999/spch287.htm.

(n8)Footnote 8. *See* Remarks by Commissioner Laura S. Unger at the American Society of Corporate Secretaries, *Dealing with the Wired Investor* (June 25, 1999) at www.sec.gov/news/speech/speecharchive/1999/spch287.htm.

(n9)Footnote 9. *See* Remarks by Commissioner Laura S. Unger at the American Society of Corporate Secretaries, *Dealing with the Wired Investor* (June 25, 1999) at www.sec.gov/news/speech/speecharchive/1999/spch287.htm.

(n10)Footnote 10. *See* Ronna Abramson, *Voices in the Corporate Wilderness*, TheStreet.com (Oct. 15, 2002) at www.thestreet.com/tech/ronnaabramson/10047135.html.

(n11)Footnote 11. *See* Ronna Abramson, *Voices in the Corporate Wilderness*, TheStreet.com (Oct. 15, 2002) at www.thestreet.com/tech/ronnaabramson/10047135.html.



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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.05

AUTHOR: Nell Minow John F. Olson

§ 2.05 A More Active Role for Mutual Funds and Money Managers

Mutual funds held \$3.6 trillion in publicly traded U.S. equity as of April 2005, an 80 percent increase since September 2002, when mutual funds held \$2.0 trillion in publicly traded U.S. equity securities representing approximately 18 percent of all publicly traded U.S. corporate equity securities.ⁿ¹ In turn, in 2004 approximately 92 million individual investors held shares of mutual funds to fund their retirements and other financial needs.ⁿ² Historically, mutual funds have been viewed as primarily passive investors, reluctant to challenge management on corporate governance issues.ⁿ³ Rather, funds have characteristically "voted with their feet," following the "Wall Street Rule" whereby investors who are dissatisfied with corporate management simply sell their stock.ⁿ⁴ However, some funds and institutional investors have become increasingly active, more assertively exercising their proxy voting responsibilities.ⁿ⁵ These votes are more closely examined in light of SEC rules adopted in 2003, requiring increased disclosure from mutual funds and money managers with respect to their proxy voting policies and procedures.

[1] Passage of SEC Proxy Voting Disclosure Rules

The SEC rule, "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies," mandates that mutual funds and investment advisers (i) disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio or client securities, (ii) disclose proxy votes that are inconsistent with their voting policies and procedures and the reasons for such votes, and (iii) file their proxy voting record with the SEC (in the case of mutual funds) or provide records of how they voted each client's proxies upon demand (in the case of money managers).ⁿ⁶ As a result of the rule, the SEC has provided investors "with the right to information that can be used to evaluate the commitment of mutual funds and investment advisers to good corporate governance and long-term shareholder value."ⁿ⁷ Investment advisers (including those to whom mutual fund boards of directors have entrusted proxy voting responsibilities) are bound by a fiduciary obligation to cast votes in accordance with the best interests of the beneficial holders,ⁿ⁸ and the rule offers clients and shareholders the means to monitor whether this fiduciary duty is being upheld. More and more investors today recognize "that poor corporate governance is an investment risk, and wish to evaluate mutual funds and advisers on how they manage this risk."ⁿ⁹

At the same time, mutual funds face criticisms for following board recommendations too closely, which in turn may encourage mutual funds to become more aggressive in seeking to separate themselves from management.ⁿ¹⁰ In a report

called "Compensation Accomplices: Mutual Funds and the Overpaid American CEO," released by the American Federation of State, County and Municipal Employees (AFSCME), the Corporate Library and the Shareowner Education Network (SEN), analyzed mutual fund voting patterns on compensation issues in 2007 and 2008. The report found that mutual funds are increasingly supportive, as a group, of management positions on proposals dealing with executive pay.ⁿ¹¹ The report found that the average level of support for company proposals on compensation issues was 82 percent in 2007 and 84 percent in 2008, a steady increase from 75.8 percent in 2006. The average level of support for the categories of compensation-related shareholder proposals was 42 percent in 2007 and 40 percent in 2008, a significant decrease from the 46.5 percent in 2006. Mutual funds did show they were more willing to withhold votes from directors over compensation issues, increasing the average level of withheld support for certain directors from 42 percent in 2007 to 52 percent in 2008.

[2] The Example of Pension Fund Activism After the "Avon Letter"

In 1988, the Department of Labor issued the "Avon Letter," an interpretive letter stating that voting rights were assets of ERISA benefit plans. This interpretive letter also held that plan fiduciaries, such as investment managers to whom power over plan assets had been delegated, were required to cast votes in accordance with the best interests of plan participants and beneficiaries.ⁿ¹² Since that time, ERISA fiduciaries have expounded and implemented proxy voting policies intended to enhance the value of plan investments and handle conflicts of interest.

ERISA fiduciaries must be discerning in their activism, however. A recent Department of Labor advisory opinion cautioned ERISA fiduciaries against the pursuit of "legislative, regulatory or public policy issues through the proxy process when there is no clear economic benefit to the plan."ⁿ¹³ The advisory opinion stated that, in the view of the Department of Labor, "the use of pension plan assets to further policy or political issues through proxy resolutions that have no connection to enhancing the value of the plan's investment in a corporation would ... violate the prudence and exclusive purpose requirements" applicable to ERISA fiduciaries under the law.ⁿ¹⁴

Just as the pension funds, under the press of the Avon Letter's interpretation of ERISA obligations, became a major force for governance reform throughout the early 1990s, we are likely to witness a surge in investment company activism in the next few years. Now, faced with public accountability for their voting practices, mutual funds and money managers will be encouraged to become more engaged in the corporate governance practices of companies whose securities are held in their portfolios, a practice that could benefit all investors.

[3] Mutual Funds and Hedge Funds Effect Significant Governance Reforms

In a speech to the New York Society of Security Analysts in 2002, John Bogle, founder of The Vanguard Group, stated that he anticipated that mutual funds would become more actively involved in corporate governance in the future.ⁿ¹⁵ In fact, mutual funds have already started to move, albeit slowly, toward activist roles in the capital markets.ⁿ¹⁶ For example, participants in a 2005 corporate governance survey indicated that half have a moderate to high level of participation in corporate governance while the other half are "not active."ⁿ¹⁷

In 2004, the SEC adopted amendments to rules under the Investment Company Act of 1940 (ICA) that set forth mandatory governance requirements for mutual funds seeking to rely on certain ICA exemptive rules.ⁿ¹⁸ Under the rule amendments, in order to engage in certain transactions otherwise prohibited under the ICA, a mutual fund would be required, among other things, to have a board with at least 75 percent independent directors and an independent chairman of the board.ⁿ¹⁹ In *Chamber of Commerce of the United States of America v. Securities and Exchange Commission*, the Court of Appeals held that the SEC's failure to consider the costs of and alternatives to the rules violated the Administrative Procedure Act and remanded the matter to the SEC for consideration of the two deficiencies.ⁿ²⁰ After a bit more than a week of reconsideration, and without inviting further public comment, the SEC decided not to modify the governance rules.ⁿ²¹ The D.C. Circuit later held that SEC was required to afford public comment on the data used to estimate the alternatives to and costs of the rules and ultimately vacated the new rules.ⁿ²²

The SEC published two studies by its economic staff, opened a new public comment period on the vacated rules, and requested other suggestions for fund governance; no action had been taken by April 30, 2009.ⁿ²³

The substantial equity holdings and corresponding voting power of mutual funds "place them in a position to have enormous influence on corporate accountability. As major shareholders, mutual funds may play a vital role in monitoring the stewardship of the companies in which they invest."ⁿ²⁴ The increased consistency and integrity of investment companies' exercise of shareholder ownership rights is likely to become a more productive and effective force and could even lead to the adoption of measures beyond proxy voting that can improve corporate governance.ⁿ²⁵ This may include more aggressive actions such as filing shareholder lawsuits or participating in the nomination of directors.ⁿ²⁶

Even more than mutual funds, hedge funds are increasing their involvement in corporate governance, although their activities have been tempered by the financial crisis. In 2007, there were more than 9,000 hedge funds with approximately \$1.3 trillion in assets compared to 3,900 hedge funds with approximately \$490 billion in assets in 2000.ⁿ²⁷ Along with this growth, hedge funds have come to realize "that you can do something to change the shareholder value [of a company] by picking on the governance side of a company."ⁿ²⁸ For example, following Blockbuster's failed takeover attempt of Hollywood Entertainment, billionaire Carl Icahn and two dissidents were elected to the Blockbuster board in 2005 with the support of hedge funds.ⁿ²⁹ At the same meeting, CEO and Chairman John Antioco lost his seat on the Blockbuster board, although the board subsequently reappointed him.ⁿ³⁰ Carl Icahn also withdrew a threatened proxy fight at Mylan Laboratories Inc. after criticizing a proposed merger between Mylan Labs and King Pharmaceuticals.ⁿ³¹ Icahn previously sued a large Mylan Labs shareholder after alleging that the investor manipulated his shares to assist Mylan Labs' acquisition. Specifically, the shareholder hedged his shares so as to retain voting control but not any economic interest.ⁿ³² OfficeMax avoided a proxy fight with a hedge fund in 2005 when the company agreed to appoint an independent director to the board and give "good faith" consideration to any candidate nominated by the hedge fund.ⁿ³³ In the summer of 2007, Richard Breeden, the former chairman of the SEC and current Chairman and CEO of Breeden Partners L.P., a hedge fund, launched a proxy contest for three seats on the board of H&R Block after disagreement with H&R Block's CEO Mark Ernst over the direction of the company, particularly its foray into the subprime mortgage lending market.ⁿ³⁴ Breeden won the proxy contest at the company's annual meeting in September of 2007 and secured at place for himself and two others on the board.ⁿ³⁵ In 2008, hedge fund investors The Children's Investment Fund and 3G Capital Partners sought five board seats at CSX Corp. CSX sought a court order to block the funds from voting part of their shares for failing to report their beneficial ownership of CSX stock. Although the court concluded that the funds had failed to properly disclose their beneficial ownership interests, it did not block them from voting their shares.ⁿ³⁶ Four dissidents were elected, and CSX ultimately seated two of them.ⁿ³⁷ In June of 2009, Carl Icahn and hedge fund Eastbourne Capital Management waged a successful proxy fight at Amylin Pharmaceuticals, ousting both the chairman of the board and the lead director.ⁿ³⁸

Hedge funds will exercise increasing influence in the corporate governance arena in the future, taking advantage of depressed stock prices and market volatility. But it is likely that hedge funds themselves will be subject to more disclosure requirements and oversight from post-financial crisis reforms.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law
Corporations
Governing Documents & Procedures
General Overview
Business & Corporate Law
Corporations
Shareholders
Meetings & Voting
Voting Shares
Proxy Agreements
Securities Law
Additional Offerings & the Securities Exchange Act of 1934
Proxies
Minimum Disclosure Standards
Securities Law
Investment Advisers
Fiduciary Responsibilities
Securities Law
Investment Companies
Capital Structure, Proxies & Voting Trusts

FOOTNOTES:

(n1)Footnote 1. See Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*:

Flows and Outstandings, First Quarter 2005, at 90 (2005); Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Flows and Outstandings*, Third Quarter 2002, at 90 (2002).

(n2)Footnote 2. See Investment Company Institute, *Mutual Fund Fact Book* 37 (45th ed. 2005).

(n3)Footnote 3. See Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 *Cardozo L. Rev.* 1419, 1430-31 (2002). See generally John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 *Cardozo L. Rev.* 837 (1994) (noting that institutional investors historically have been passive investors).

(n4)Footnote 4. See SEC Division of Corporate Finance, Staff Report on Corporate Accountability 392 (Sept. 4, 1980) (describing the "Wall Street Rule").

(n5)Footnote 5. See, e.g., Aaron Lucchetti, *A Mutual-Fund Giant is Stalking Excessive Pay*, Wall St. J., June 12, 2002, at C1 (noting that Fidelity has voted against management compensation recommendations that it feels are excessive); Kathleen Day, *Prodding for Disclosure of Funds' Proxy Votes*, Wash. Post, Apr. 8, 2001, at H1 (discussing Domini Equity Social Fund's vote against a management proposal concerning equity compensation for directors); Josh Friedman, *Vanguard to Turn More Activist in Proxy Voting*, L.A. Times, Aug. 22, 2002, at Bus. 1 (discussing Vanguard's announcement that it will adhere to stricter standards for corporate governance in its proxy voting).

(n6)Footnote 6. See SEC Release No. 34-47304, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (Jan. 23, 2003). The adoption of these rules was lauded by shareholder activists as an important decision by the SEC to protect the rights of all investors. "It is important to remember that corporate scandals like Enron, Tyco, and WorldCom were not caused by executive greed alone. Mutual funds were among those who approved Enron's board of directors, supported CEO compensation packages, and voted against numerous corporate governance measures that may well have prevented some of the abuses we've recently witnessed." Statement of Timothy Smith, *On the SEC Mutual Fund/Investment Advisor [sic] Proxy Vote Rule* (Jan. 23, 2002). Additionally, the disclosure of proxy voting will help ensure that mutual funds and money managers do not give in to conflicts of interest that may tempt them to subordinate client and shareholder interests to their own. See Nell Minow and Beth Young, Comment Letter to the SEC re: the Commission's Proposed Rules Requiring Disclosure by Investment Advisers and Mutual Funds of Proxy Voting Policies (Dec. 3, 2002). The SEC's approval of the rules requiring proxy disclosure "tears away the cloak of secrecy that up to now has shielded mutual fund proxy voting from much-needed public scrutiny." Statement of Timothy Smith at www.socialinvest.org/Areas/News/030128.htm.

(n7)Footnote 7. Statement of Timothy Smith, *On the SEC Mutual Fund/Investment Advisor [sic] Proxy Vote Rule* (Jan. 23, 2002), Social Investment Forum.

(n8)Footnote 8. See SEC Release No. 34-46518, *Proposed Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (Sept. 26, 2002).

(n9)Footnote 9. Nell Minow and Beth Young, Comment Letter to the SEC re: the Commission's Proposed Rules Requiring Disclosure by Investment Advisers and Mutual Funds of Proxy Voting Policies (Dec. 3, 2002), Social Investment Forum. See also Statement of Timothy Smith, *On the SEC Mutual Fund/Investment Advisor [sic] Proxy Vote Rule* (Jan. 23, 2002), Social Investment Forum ("Investors today understand the importance of good governance, ethics and corporate citizenship in the companies in which they invest through mutual funds. They want to see if mutual funds 'get it' and are voting thoughtfully and conscientiously on their behalf").

(n10)Footnote 10. William Baue, *Mutual Funds Bite the Hand that Feeds: Mutual Fund Ties to Corporate Clients Can Affect Proxy Voting*, available at www.socialfunds.com/news/article.cgi/article1659.html (finding that there is no sign that proxy voting by mutual funds depends on whether a firm is a client or not and that "the more business ties a fund company has, the less likely it is to vote in favor of shareholder proposals opposed by management").

(n11)Footnote 11. See *Compensation Accomplices: Mutual Funds and the Overpaid American CEO* (2008),

available at http://www.afscme.org/docs/mutual_Fund_full_report.pdf.

(n12)Footnote 12. See Dept. of Labor Op. Ltr. to Helmuth Fandl, Avon Products, Inc. (Feb. 29, 1988).

(n13)Footnote 13. See DOL Advisory Opinion 2007-07A (December 21, 2007), available at <http://www.dol.gov/ebsa/regs/aos/ao2007-07a.html>.

(n14)Footnote 14. DOL Advisory Opinion 2007-07A (December 21, 2007), available at <http://www.dol.gov/ebsa/regs/aos/ao2007-07a.html>.

(n15)Footnote 15. See John C. Bogle, Just When We Need It Most ... Is Corporate Governance Letting Us Down?, Remarks before the N.Y. Society of Security Analysts (Feb. 14, 2002), available at www.vanguard.com/bogle_site/sp20020214.html ("Corporate governance *has* let us down, and it has let us down just when we needed it most. But if the firms in the mutual fund industry realize that--as representatives of the owners of nearly half of the corporate stock in our nation--they are the *ultimate* governors, we can make sure that corporate governance never lets us down again.").

(n16)Footnote 16. "For big investors, picking fights with corporate America is becoming fashionable again. After a decade of giving companies rubber-stamp approvals for everything from auditors to luxurious stock-option grants, many say they're taking a more active stance after the financial scandals at Enron, Global Crossing, and WorldCom." Beth Healy, *Big Investors Assuming a More Activist Stance*, Boston Globe, July 11, 2002, at C1.

(n17)Footnote 17. Investment News, Vol. 9, Issue 15 (Apr. 18, 2005) (based on a survey of 100 pension funds, money managers and hedge funds conducted by Pensions & Investments magazine and Vivient Consulting LLC).

(n18)Footnote 18. See SEC Release No. IC-26520 (July 27, 2004), available at <http://www.sec.gov/rules/final/ic-26520.htm>.

(n19)Footnote 19. See SEC Release No. IC-26520 (July 27, 2004), available at <http://www.sec.gov/rules/final/ic-26520.htm>.

(n20)Footnote 20. See *Chamber of Commerce of the United States of America v. Securities and Exchange Commission*, 412 F.3d 133 (D.C. Cir. 2005) .

(n21)Footnote 21. See SEC Release No. IC-26985 (June 30, 2005), available at <http://www.sec.gov/rules/final/ic-26985.pdf>.

(n22)Footnote 22. See *Chamber of Commerce of the United States of America v. Securities and Exchange Commission*, 443 F.3d 890 (D.C. Cir. 2006) .

(n23)Footnote 23. See SEC Release No. IC-27600 (December 15, 2006), available at <http://www.sec.gov/rules/final/ic-26520.htm>.

(n24)Footnote 24. SEC Release No. 34-47304, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (Jan. 23, 2003). See also Russ Wiles, *Funds May Have More to Say on Governance*, Chi. Sun-Times, June 3, 2002, at 53 (citing Domini Funds' chief Amy Domini, "[m]utual funds arguably now hold the swing vote when it comes to deciding how U.S. corporations are governed").

(n25)Footnote 25. In 2002 Jamie Heard, the chief executive of RiskMetrics Group ("RMG") (formerly Institutional Shareholder Services, a company that, among other services, advises mutual funds, pension funds and foundations on proxy voting), stated that not only was RMG's client list expanding, but the company also was hearing more frequently from existing clients who were increasingly interested in taking action on governance issues. Additionally, Heard described a Boston mutual fund firm's request that RMG make an in-house presentation to its executives to address

measures beyond proxy voting that may improve corporate governance. See Beth Healy, *Big Investors Assuming a More Activist Stance*, Boston Globe, July 11, 2002, at C1.

(n26)Footnote 26. See Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, Pub. Aff. Rev. 10, 12 (2003).

(n27)Footnote 27. Chris Clair, *Lenox Carving Out Wealth, Benefits Advisor Niche*, Hedge World Daily News, January 12, 2007. See also William W. Bratton, *Hedge Funds and Governance Targets* (Georgetown Law and Econ. Research Paper No. 928689, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928689 (tracking the influence of activist hedge funds on their target companies); Kaja Whitehouse, *Move Over CEO: Here Come the Directors*, Wall St. J., Oct. 9, 2006, at R1; *Why Corporate Boardrooms are in Turmoil*, Wall St. J., Sept. 16-17, 2006, at A7.

(n28)Footnote 28. Rachel Beck, *Hedge fund activism sparks concerns*, Myrtle Beach Sun News, May 21, 2005 at D2 (citing B. Espen Eckbo, founding director of the Center for Corporate Change at Dartmouth College).

(n29)Footnote 29. Rachel Beck, *Hedge fund activism sparks concerns*, Myrtle Beach Sun News, May 21, 2005 at D2.

(n30)Footnote 30. *Icahn Slate Wins Blockbuster Vote*, CFO Magazine, May 12, 2005. This is despite Mr. Antioco's earlier statements that he would resign if not reelected to Blockbuster's board. *Blockbuster CEO says he'll quit if ousted from board*, Baltimore Sun, April 28, 2005.

(n31)Footnote 31. Michael Yeomans, *Icahn offers to sell stock*, Pittsburgh Tribune-Review (July 18, 2005).

(n32)Footnote 32. *Icahn Cries Foul Play at Perry's No-Risk Play*, Wall St. J., (Dec. 15, 2004) at C1.

(n33)Footnote 33. Stephen Taub, *SEC Launches Formal Probe of OfficeMax*, CFO.com, June 14, 2005, available at <http://www.cfo.com/article.cfm/4077139?f=search>.

(n34)Footnote 34. See Yalman Onaran, *H&R Block Investors Put Breeden on Board; Pressure on CEO Rises*, Bloomberg.com, September 6, 2007, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a7kWxNxa.ZQI>.

(n35)Footnote 35. See *Breeden Partners' Three Nominees Overwhelmingly Elected to H&R Block's Board of Directors*, Forbes.com, September 6, 2007, available at <http://www.forbes.com/businesswire/feeds/businesswire/2007/09/06/businesswire20070906005799r1.html>.

(n36)Footnote 36. *CSX Corporation v. The Children's Investment Fund Management (UK) L.L.P. et al* (1:08-cv-02764-LAK (filed Mar. 17, 2008)).

(n37)Footnote 37. Christopher Young and Ted Allen, *Amid the Credit Crisis, More Proxy Fights and Fewer Deals*, RiskMetrics Group 2008 Post-Season Report at 29.

(n38)Footnote 38. Subodh Mishra, RiskMetrics Group 2009 U.S. Proxy Season Trends at 9.



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Corporate Governance: Law and Practice

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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.06

AUTHOR: Nell Minow John F. Olson

§ 2.06 New Alternatives Will Increase Punishments for Executive Wrongdoing

[1] Pressure on Settlements Without Admissions or Denials of Guilt

In June 2003 six former senior executives at Xerox Corporation, including two former CEOs and the former CFO, settled an SEC enforcement action charging them with fraud. The SEC alleged that, in an effort to boost the company's share price, these top executives had engaged in a fraudulent scheme that overstated the company's revenues by approximately \$3 billion and inflated pre-tax earnings by approximately \$1.4 billion between 1997 and 2000. As a result of the settlement, the six defendants agreed to pay over \$22 million in penalties, disgorgement and interest, though they were not required to admit or deny the SEC's allegations.ⁿ¹

It is common practice for the SEC to allow companies, directors and officers to settle cases without admitting or denying the charges against them, as was the case with the Xerox settlement.ⁿ² As a result, the company may not be statutorily barred from using company resources to pay the cost of directors' and officers' legal defense or to cover fines or other penalties assessed against them. Additionally, some D&O liability policies may provide coverage for the directors and officers.ⁿ³ In many past instances, directors and officers who have settled SEC charges without admitting or denying the Commission's charges have been fully indemnified by the company and have continued to conduct business as usual in the same corporate posts.ⁿ⁴ Though the former Xerox executives were required to pay a small portion of the penalties out of their personal funds, the company indemnified them for the majority of the costs of the settlement.ⁿ⁵

Critics of settlements without admissions of guilt argue that when the accused directors and officers settle with the SEC without admitting wrongdoing, the subsequent availability of corporate indemnification is an unfortunate result in that the shareholders, as the owners of the company, suffer not only corporate losses resulting from the management misconduct, but also are called upon to subsidize the penalties incurred by the offenders.ⁿ⁶ This is a difficult issue. The practice of indemnification initially developed to shield directors and officers from liability that might discourage them from taking necessary business risks and to safeguard them from third-party lawsuits, which may be baseless. Further, the SEC's ability to obtain beneficial settlements and garner its own enforcement resources may be negatively affected if it no longer offers settlement without admissions of guilt.ⁿ⁷

The SEC has acknowledged the potential inequity resulting from reimbursement and indemnification and in some cases has required that settling individuals pay their own civil fines. In the Xerox settlement, for example, the settlement language stated that defendants "shall not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made by any issuer or pursuant to any insurance policy with regard to the civil penalty amounts."⁸ The agreement also prohibited the defendants from claiming, asserting or applying for a tax deduction or credit with respect to the penalty amounts.⁹ Former Commissioner Harvey Goldschmid stated that "[i]t's critical [that] when [the Commission] takes money for a civil penalty, which involves a serious wrong, the money not circle back into the hands of those who have been involved in the wrongdoing" through indemnification.¹⁰ Additionally, in a speech before the New York Financial Writers in June 2003, then SEC Chairman Bill Donaldson also acknowledged the problem: "I'm concerned about companies that, under permissive state laws, indemnify their officers and directors against disgorgement and penalties ordered in law enforcement actions, including those brought by the Commission. In my mind, this just isn't good public policy. This is an area in which we may need to consider ways to bring about reform."¹¹ In her first speech as Chairman of the SEC, Chairman Mary Schapiro announced an end to a two-year "pilot" program established by former SEC Chairman Christopher Cox, which had required the staff of the SEC's Division of Enforcement to obtain advance approval of proposed penalties from the Commission in cases seeking civil monetary penalties against public companies as a sanction for securities fraud.¹² Even though the pilot program affected only a handful of cases, the program had been subject to criticism for adding delay to the settlement process and potentially reducing the penalties assessed against companies. Speaking more broadly, Chairman Schapiro stated that she anticipates further improvements "to ensure swift and vigorous enforcement," clearly signaling an intent to make good on her promise at her confirmation hearings to reinvigorate SEC enforcement.

As awareness of the availability of corporate reimbursement for executive wrongdoing increases among shareholders, it may become a more central issue in reform movements. Activists may encourage the Commission, Congress, state legislatures and the courts to mandate changes requiring an increased degree of personal liability for directors and officers whose actions reflect corruption, self-dealing or even a conscious disregard of duty. As we have noted, however, the importance to the SEC of resolving enforcement actions through settlements must be underscored; it is doubtful that the Commission has either the resources or the staff to try all of the more than 500 enforcement cases that it files every year. Defense attorneys will be more reluctant to settle cases if such a settlement would require both an admission of guilt and an increase in personal monetary liability for the targets.

[2] Expansion of Alternative Punishments for Executive Wrongdoing

In its arsenal, the Commission already has highly potent enforcement tools that can be directed at corporate managers and directors. In addition to the power to seek monetary civil remedies (which now may not be indemnifiable), the Commission has authority to seek permanent injunctions, cease-and-desist orders, officer and director bars and suspensions from practice before the Commission.¹³ The Commission also may refer appropriate matters to criminal authorities for prosecution.¹⁴

Additionally, several provisions of the Sarbanes-Oxley Act augment the Commission's authority and ability to effectively enforce the federal securities laws. For example, Section 304, enforceable by the SEC but not by private litigants, requires the CEO and CFO to reimburse the company for any bonus, incentive- or equity-based compensation or any profit from the sale of company securities obtained during the 12 months prior to the period covered by any earnings restatement resulting from a company's noncompliance with reporting requirements as a result of "misconduct."¹⁵ Section 305 expands the scope of the officer and director bar, allowing the Commission to remove directors and officers in administrative, not just judicial, proceedings and to bar them from serving in similar capacities at other companies upon showing their "unfitness."¹⁶

The unusual \$80 million settlement of a securities fraud lawsuit against Hanover Compressor in May 2003 demonstrates another option to more effectively provide redress to injured shareholders. The groundbreaking settlement allowed Hanover's shareholders holding more than one percent of company stock to nominate two independent directors to the

company's slate of candidates in the upcoming proxy season.¹⁷ A first such settlement among publicly traded companies, the settlement provides shareholders with "sweeping new powers to police potential accounting fraud."¹⁸

In another settlement, Siebel Systems, Inc., a provider of customer-service software, resolved a derivative suit brought by a Louisiana pension fund by agreeing to change its executive compensation practices, modify its board, and improve its disclosure of director and executive pay, among other things.¹⁹ Lawsuits like the ones at Siebel Systems and Hanover Compressor "are not just to recoup money anymore;" rather, they increasingly involve compelling companies to change their practices.²⁰

The Department of Justice demonstrated its willingness to consider alternative approaches to handling executive wrongdoing when in 2005 it agreed to defer prosecution of Bristol-Myers for conspiring to commit securities fraud.²¹ Pursuant to the agreement, Bristol-Myers would be required, among other things, engage an independent monitor to oversee the company's remediation efforts and report to the Department of Justice on a regular basis.²² The Department of Justice agreed that if at the end of 24 months, Bristol-Myers has complied with its obligations under the agreement, it would dismiss the criminal complaint against the company.²³ In August 2005, the Department of Justice entered into a similar agreement with KPMG in which the government agreed to defer an indictment of KPMG related to the sale of improper tax shelters.²⁴ Under the deferred-prosecution agreement, the company was required to submit to outside monitoring, pay a \$456 million fine, and dispose of certain of its tax--advisory businesses.²⁵ In January 2007, at the request of the U.S. Attorney for the Southern District of New York, a federal judge dismissed the deferred criminal charge.²⁶ However, a monitor will remain in place at the company until September 2008 to ensure that KPMG continues to comply with the terms of the agreement.²⁷

The SEC has also demonstrated flexibility in its pursuit of remediation for corporate wrongdoing. In October of 2006, the SEC commenced administrative proceedings against Statoil for violations of the Foreign Corrupt Practices Act (FCPA) stemming from payments to an Iranian official in exchange for oil contracts in 2002 and 2003.²⁸ It was determined by the SEC that "during the relevant time period, Statoil employees circumvented Statoil's internal controls and procedures that were in place to prevent illegal payments, and Statoil lacked sufficient internal controls."²⁹ On October 13, 2006, the SEC and DOJ agreed to suspend further proceedings against Statoil on the condition that the company retain an independent compliance consultant, take certain remedial measures to strengthen its internal controls and disgorge over \$10 million to the U.S. Treasury.³⁰

Similarly, the SEC filed FCPA charges in August of 2007 against Textron, Inc. for, among other things, alleged kickbacks to Iraqi officials while participating in the U.N. Oil for Food Program. The SEC found that Textron either "knew or was reckless in not knowing that illicit payments were paid [and] failed to maintain an adequate system of internal controls to detect and prevent the payments."³¹ The SEC and the DOJ accepted Textron's offer of settlement and agreed to pursue no further action against Textron on the condition that the company take certain remedial measures to bolster its FCPA compliance program and to pay over \$3.5 million.³²

The examples set by Hanover, Siebel Systems, Bristol-Myers, Statoil and Textron have the potential to pave the way for the development of other remedies providing increased accountability to shareholders where the SEC believes governance has failed.³³

[3] The Commission's Vigorous Use of Non-Monetary Remedies

Although the Commission did not frequently invoke the officer and director bar in the past, it has increasingly exercised the remedy as part of heightened overall efforts to combat corporate fraud.³⁴ During the Commission's 2003 fiscal year, the Commission sought 170 officer and director bars, up from 38 in fiscal year 2000.³⁵ More recently, the Commission invoked the officer and director bar against the former general counsel of Computer Associates International, Inc.³⁶ Additionally, the SEC has increasingly invoked the remedy of disgorgement. By 2002, "the number of individuals from whom disgorgement of compensation was sought ha[d] risen by 88 percent in the past three

years."³⁷ More recently, the Justice Department has increasingly brought criminal charges against high-profile corporate defendants, including Bernard Ebbers, who was sentenced to 25 years in prison following the \$11 billion accounting fraud at WorldCom, and Richard Scrushy, who was acquitted by a jury of 36 criminal charges following the \$2.7 billion accounting fraud at HealthSouth.³⁸

Responding to former SEC Chairman Donaldson's expressed goal to shift the balance of power away from "imperial CEOs" and back toward investors and the board, the Commission has stepped up enforcement efforts across the board. As Congress nearly doubled the Commission's budget to \$841.5 million for the fiscal year beginning in October 2003, according to Donaldson the SEC would continue "flexing a reinvigorated enforcement muscle at corporate America."³⁹ Though the Commission appears likely to maintain its aggressive efforts to prosecute corporate fraud overall, it is likely that the Commission will face mounting pressure to pair monetary remedies with non-monetary remedies that hold the wrongdoers individually accountable.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Directors & Officers

FOOTNOTES:

(n1)Footnote 1. *See* SEC Litigation Release No. 18174 (June 5, 2003).

(n2)Footnote 2. *See* 2002 SEC Ann. Rep. (2002), available at www.sec.gov/pdf/annrep02/ar02enforce.pdf. The SEC reported that in 2002, "[m]ost of ... [its] enforcement actions were resolved by settlement with the defendants or respondents, who generally consented to the entry of judicial or administrative orders without admitting or denying the allegations against them." 2002 SEC Ann. Rep. 2 (2002).

(n3)Footnote 3. *See* Chapter 5 below for further discussion of indemnification and D&O insurance.

(n4)Footnote 4. *See* Monica Langley, *Big Companies Get Low Marks for Lavish Executive Pay*, Wall St. J., June 9, 2003, at C1 (citing The Corporate Library's criticism of Citigroup, Inc. and J.P. Morgan Chase for incurring massive fines in a regulatory settlement over manipulated stock research while the companies' respective CEOs and their boards haven't been held personally accountable--over \$480 million in penalties have been paid by the companies' shareholders). *See also* Paul Hodgson, *Citigroup, Inc.(C) Still Worst Overall*, The Corporate Library Special Report (July 2003) (noting that Citigroup's fines were paid by its current shareholders rather than by any of its officers).

(n5)Footnote 5. *See* Xerox Corporation's Amendment No. 3 to its Registration Statement on Form S-3, filed with the SEC on June 6, 2003 ("Because all of the individuals who settled were officers of Xerox, [the company is] required to pay the disgorgement amounts (\$19.4 million including prejudgment interest) and legal fees associated with their settlements. Under the terms of [the company's] by-laws, [the company is] required to indemnify officers and directors ... against any costs, expenses or liabilities that result from acting as an officer or director, including payments made in settlement of proceedings, unless the officers or directors are found guilty of wrongdoing in a court of law.").

(n6)Footnote 6. *See* Nell Minow, *Shareholders Victimized Twice by Corporate Scandals*, USA Today.com, July 6, 2003, at www.usatoday.com/news/opinion/editorials/2003-07-06-opcom_x.htm ("One of the saddest consequences of the corporate accounting scandals is that shareholders are victimized twice: first by the losses incurred by those committing financial crimes and again when they subsidize the penalties these crooked executives incur."). *See also* Elizabeth MacDonald, *The Toothless Poodles*, Forbes.com, Sept. 16, 2003, available at www.forbes.com/2003/09/16/cz_em_0916wallstreet_print.html (supporting Minow's note that "corporate crookedness wipes out jobs and shareholder value. But it's often the shareholders, not the crooks, who end up paying the fines through the corporate treasury or through increased premiums to corporate insurance. There's something seriously wrong with a system where the penalty for frauds that wipe out jobs and shareholder value is paid by the shareholders

injured, not the executives who inflict the injury").

(n7)Footnote 7. See Nell Minow, *Shareholders Victimized Twice by Corporate Scandals*, USA Today.com, July 6, 2003, available at www.usatoday.com/news/opinion/editorials/2003-07-06-opcom_x.htm; Elizabeth MacDonald, *The Toothless Poodles*, Forbes.com, Sept. 16, 2003, at www.forbes.com/2003/09/16/cz_em_0916wallstreet_print.html.

(n8)Footnote 8. Robert Schmidt, *SEC Wants Settlements in which Defendants Pay Own Fines*, Chi. Sun-Times, June 17, 2003, at Fin. 49. As noted above, however, the company did pay certain disgorgement amounts and legal fees.

(n9)Footnote 9. See Robert Schmidt, *SEC Wants Settlements in which Defendants Pay Own Fines*, Chi. Sun-Times, June 17, 2003, at Fin. 49.

(n10)Footnote 10. Robert Schmidt, *SEC Wants Settlements in which Defendants Pay Own Fines*, Chi. Sun-Times, June 17, 2003, at Fin. 49, quoting then Commissioner Harvey Goldschmid.

(n11)Footnote 11. Chairman William H. Donaldson, Speech by SEC Chairman: Remarks Before the New York Financial Writers Association (June 5, 2003), available at www.sec.gov/news/speech/spch060503whd.htm. See also Elizabeth MacDonald, *The Toothless Poodles*, Forbes.com, Sept. 16, 2003, available at www.forbes.com/2003/09/16/cz_em_0916wallstreet_print.html (stating that the SEC is quietly trying to start treating "defendants who agree to injunctive orders as having admitted to the charges, despite the boilerplate settlement language").

(n12)Footnote 12. See SEC Chairman Mary L. Schapiro, Address to Practicing Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), available at <http://sec.gov/news/speech/2009/spch020609mls.htm>.

(n13)Footnote 13. See Securities and Exchange Commission, *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002*, 41 (Jan. 24, 2003).

(n14)Footnote 14. See Securities and Exchange Commission, *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002*, 41 (Jan. 24, 2003).

(n15)Footnote 15. See 15 U.S.C. § 7243 (2003); SEC Press Release 2007-255 (December 6, 2007), available at <http://www.sec.gov/news/press/2007/2007-255.htm> (announcing the first settlement under Section 304, in the amount of \$468 million, Executive Officer and Chairman of the Board of UnitedHealth Group, Inc. for options backdating). See also § 16.04 below discussing Sarbanes-Oxley § 304.

(n16)Footnote 16. See 15 U.S.C. § 78t-78u (2003). Note that the prior standard for use of the officer and director bar required a showing of "substantial unfitness."

(n17)Footnote 17. See Press Release, *Hanover Compressor Announces Settlement of Securities Litigation* (May 13, 2003); Edward Iwata, *Shareholders Win In Hanover Settlement*, USA Today, May 14, 2003, at 3B.

(n18)Footnote 18. Edward Iwata, *Shareholders Win In Hanover Settlement*, USA Today, May 14, 2003, at 3B.

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(n20)Footnote 20. Ed Zwirn, *Another Company Bows Before Shareholders*, CFO.com Aug. 28, 2003, available at www.cfo.com/article/1,5309,10547,00.html?f=related.

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(n23)Footnote 23. Stephen Taub, *Bristol's Former CFO Indicted*, June 17, 2005, available at http://www.cfo.com/printable/article.cfm/4096065/c_4096737?f=options.

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(n30)Footnote 30. *Id.*; DOJ Press Release, *U.S. Resolves Probe Against Oil Company that Bribed Iranian Official*, October 13, 2006, available at <http://www.usdoj.gov/usao/nys/pressreleases/October06/statoildeferredprosecutionagreementpr.pdf>.

(n31)Footnote 31. See SEC Litigation Release No. 20251 (August 23, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20251.htm>.

(n32)Footnote 32. *Id.*; DOJ Press Release, *Textron Inc. Agrees to \$1.15 Million Fine in Connection with Payment of \$600,000 in Kickbacks by its French Subsidiaries under the United Nations Oil for Food Program*, August 23, 2007, available at http://www.usdoj.gov/opa/pr/2007/August/07_crm_646.html.

(n33)Footnote 33. For additional discussion of corporate governance enhancements achieved as part of negotiated settlements, see § 2.01[5] above.

(n34)Footnote 34. As an example, in the Xerox settlement the SEC barred four of the six defendants from serving in similar capacities at public companies for varying periods of time. The former Xerox CFO, Barry Romeril, was permanently barred from serving at other public companies. Xerox's former Chairman and CEO, Paul Allaire, and Philip Fishbach, the former Controller, were barred from similar positions for a period of five years. G. Richard Thoman, the former President, COO and CEO, was barred for a period of three years. See SEC Litigation Release No. 18174 (June 5, 2003).

(n35)Footnote 35. Stephen M. Cutler, Director, SEC Division of Enforcement, Remarks before the District of Columbia Bar Association, (Feb. 11, 2004).

(n36)Footnote 36. *SEC Files Securities Fraud Charges Against Computer Associates International, Inc.*, States News Service (Sept. 22, 2004).

(n37)Footnote 37. House Committee on Financial Services, *The Sarbanes-Oxley Act: The First Year* (2003).

(n38)Footnote 38. See Carrie Johnson, *Ebbers Gets 25-Year Sentence for Role in WorldCom Fraud*, Wash. Post,

July 14, 2005, at A1; Lewis, *House that Scrushy Built Moving On*, Denver Post, July 8, 2005, at C1.

(n39)Footnote 39. Meg Richards, *Almost one year later, effects of Sarbanes-Oxley remain fuzzy*, S.F. Chron., July 27, 2003, at I1.



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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

*1-2 Corporate Governance: Law and Practice § 2.07***AUTHOR:** Nell Minow John F. Olson**§ 2.07 Internationalization of Corporate Governance**

Interest in corporate governance is not limited to U.S. investors. A recent ServicesRiskMetrics Group (RMG) survey of 322 institutional investors in 18 countries found that a majority of investors in every market consider corporate governance to be important to their firms.ⁿ¹ As corporate governance becomes an international issue, U.S. investors are increasingly looking to the governance practices of foreign companies, which shape investors' views of corporate governance in the United States. One example of this movement is the burgeoning number of shareholder proposals seeking an advisory vote on executive compensation.ⁿ² The focus on shareholder influence over executive pay practices through an advisory vote mechanism has gained popularity with some advocacy groups in the U.S. as a result of such a requirement in the United Kingdom. In 2002, the United Kingdom became the first country to adopt legislation requiring companies to submit the company's annual compensation disclosure statement--the "Directors' Remuneration Report"--to shareholders for a non-binding vote at the company's annual meeting.ⁿ³ Specifically, shareholders may vote on whether to accept or reject the remuneration report as a whole.ⁿ⁴ The remuneration report generally contains executive compensation disclosures equivalent to those required of U.S. companies under SEC rules, including the company's compensation philosophy and actual compensation paid.ⁿ⁵ In 2004, the Netherlands followed suit, incorporating into its Civil Code even stronger provisions requiring public companies to submit remuneration reports to shareholders for a binding vote.ⁿ⁶ Soon after, Sweden and Australia both adopted legislation based on the U.K. model.ⁿ⁷ On April 20, 2007, the U.S. House of Representatives approved "The Shareholder Vote on Executive Compensation Act," which, if adopted, would have required that shareholders approve executive compensation plans.ⁿ⁸ A companion bill introduced in the Senate was never acted on.ⁿ⁹ More recently, Senators Charles Schumer and Maria Cantwell introduced the "Shareholder *Bill of Rights* Act of 2009" in the Senate, and Congressman Gary Peters introduced the "Shareholder Empowerment Act of 2009" in the House of Representatives. These bills, if adopted, would give shareholders an annual non-binding vote on executive compensation.ⁿ¹⁰

Another issue that has garnered the attention of U.S. companies and shareholders is shareholder access to companies' proxy statements, a right that shareholders in the United Kingdom have had since the Companies Act 1985.ⁿ¹¹ The Act grants certain large shareholders or shareholder groups the right to include a resolution for the appointment of a director at an Annual General Meeting of shareholders. Such a resolution requires a simple majority vote and is binding on the company. Similar rules apply in Australia, France, Germany, India, South Africa, and Sweden, among other countries. Some U.S. shareholder advocacy groups hoping to achieve stronger influence over board members have pressed for

SEC adoption of rules to the same effect in the United States. On November 28, 2007, however, the SEC declined to adopt a shareholder proxy access rule and reaffirmed its position that Rule 14a-8(i)(8) allows companies to exclude shareholder proposals relating to director nominations from their proxy statements.ⁿ¹² Then-SEC Chairman Cox stated that the SEC would revisit the issue as early as spring of 2008 in the hopes of finalizing a proposal on shareholder proxy access by November.

Chairman Cox' promise to revisit the issue did little to quiet some proxy access proponents, though. The American Federation of State and County Municipal Employees, for example, proceeded to submit proxy access shareholder proposals for consideration at the 2008 annual meetings of several companies, including Countrywide Financial Corporation, The Bear Stearns Companies Inc., JPMorgan Chase & Co. and E-Trade Financial Corporation, and even threatened to bring suit if the companies failed to include these proposals in their proxy materials.ⁿ¹³ Although the proxy access proposal anticipated by Chairman Cox was never finalized, the SEC revived the issue of proxy access on May 20, 2009 by approving the publication of proposed amendments to the SEC's proxy rules to permit shareholders to nominate directors in a company's proxy materials.ⁿ¹⁴

A prime example of the universality of governance issues is electronic delivery of proxy materials. As discussed above, the Commission adopted rules in 2006 that allow companies to deliver proxy materials to shareholders via the internet and adopted additional rules in 2007 which require large accelerated filers to post proxy materials on their website beginning January 1, 2008, and all other companies to do the same beginning January 1, 2009.ⁿ¹⁵ The adoption of these new rules in the United States coincided with the adoption of legislation in the United Kingdom clarifying that Britain's electronic proxy rule that had been adopted in 2000 permits companies to use electronic communications as the default method of communicating with shareholders. As an increasing number of U.S. shareholders and institutional investors seek to import international trends in corporate governance to the United States, it is important to consider how particular governance issues align with the overall system of corporate governance in the U.S.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Foreign Businesses Noncompliance

FOOTNOTES:

(n1)Footnote 1. Institutional Investors Services 2006 ISS Global Institutional Investor Study, *available at* <http://www.issproxy.com/pdf/2006GlobalInvestorStudy.pdf>.

(n2)Footnote 2. *See* ISS 2007 Proxy Season Watchlist, *available at* <http://www.issproxy.com/ProxySeasonWatchlist/2007/index.jsp>. For further discussion of this topic, *see* § 2.03[1].

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(n14)Footnote 14. SEC Press Release 2009-116 (May 20, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-116.htm>.

(n15)Footnote 15. *See* Opening Statement of the Division of Corporation Finance at the SEC Open Meeting (June 20, 2007) *available at* <http://www.sec.gov/news/speech/2007/spch062007rab.htm>. For further discussion of this topic, *see* § 2.04.



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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.08

AUTHOR: Nell Minow John F. Olson

§ 2.08 Are Directors Effective Corporate Monitors?

[1] Boardroom Culture Can Impede Director Independence and Action

In discussing failures of "intelligent and decent" directors to serve as effective monitors against corporate wrongdoing, Warren Buffett, Chairman of Berkshire Hathaway Inc., laid part of the blame on the impediment that he calls "boardroom atmosphere."¹ Having himself served on 20 public company boards over a span of 40 years, Buffett described "social difficulties" associated with board membership that may deter otherwise able and loyal directors from successfully stewarding a company. For instance, Buffett stated that "it's almost impossible ... in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced."² In Buffett's view, on many boards, questioning the compensation committee's grants to the CEO would be the equivalent of "belching at the dinner table."³

In the context of describing the failure of directors on other boards to question foolish acquisitions or egregious compensation, Buffett admitted, "My own behavior, I must ruefully add, frequently fell short as well: Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence."⁴ If Warren Buffett, a financially independent, business-savvy, motivated and shareholder-oriented director, admittedly has backed down in boardrooms due to social pressure, it is safe to posit that many other directors have done the same thing on far too many occasions.

When otherwise competent, intelligent and independent directors succumb to conformist pressures and fail to challenge imprudent management decisions, boardroom culture needs to change. Directors can only effectively promote corporate success and investor interests by asking hard questions, demanding proper analysis and assertively challenging management when necessary. In the words of Chief Justice Veasey, "[d]irectors who are supposed to be independent should have the guts to be a pain in the neck and act independently."⁵ Directors "should behave as if there was a single absentee owner, whose long-term interest they should try to further in all proper ways. This means that directors must get rid of a manager who is mediocre or worse, no matter how likable he [or she] may be."⁶

Fortunately, it appears that boards are getting tougher, and boardroom culture is evolving. Directors are becoming more comfortable challenging received wisdom and are increasingly likely to reject management proposals that they feel are

unwise. As described by Terry Gallagher, CEO of Corporate Governance Associates, "[a]t many companies, I hear that the boardroom culture clearly has shifted as directors appear much more willing to ask hard questions and probe underneath the surface at companies. This cultural evolution should continue for a few years as the full impact of Sarbanes-Oxley creeps into the corporate governance backbone of these companies."⁷ Moreover, at least one observer considers the rise of "executive sessions" to be "absolutely the most important thing that's happened" in creating independent boards of directors.⁸ Executive sessions have increased dramatically over the last few years, in large part due to the NYSE's listing standards requiring that a board's non-management directors meet at regularly scheduled executive sessions without the presence of management.⁹ "The idea is to allow board members to raise sensitive issues--from executive pay and management style to lackluster performance--that they would find difficult to confront with the chief executive in the room."¹⁰ Executive sessions typically are led by the chairman of the board, if that person is not also the CEO, and in other cases a company may appoint a lead director or presiding director to serve this function.¹¹ In order to be effective, executive sessions should include, among other things, agendas developed based on input from other directors, and examination of difficult issues. Most important is engaging in subsequent conversations with the CEO and other senior management about concerns raised and evaluation of management's response. Hopefully directors will continue to develop a new culture based on constructive skepticism and active, independent oversight.

The financial crisis led to criticism of boards of directors for corporate governance failures, such as executive compensation practices that encourage excessive risk-taking and lax board oversight of risk management. In light of this increased scrutiny, boards will need to examine their executive compensation and risk management practices to see that they are rewarding behavior that will most likely result in the achievement of strategic goals and to ensure adequate assessment of current risks and anticipation of future risks.

[2] It is Difficult to Predict Board Performance on Paper

At the Center for Business Ethics at Houston's University of St. Thomas, a powerful and well-known CEO remarked on corporate governance at his company:

[A] strong, independent, and knowledgeable board can make a significant difference in the performance of any company ... [O]ur corporate governance guidelines emphasize 'the qualities of strength of character, an inquiring and independent mind, practical wisdom and mature judgment.' It is no accident that we put 'strength of character' first. Like any successful company, we must have directors who start with what is right, who do not have hidden agendas, and who strive to make judgments about what is best for the company, and not about what is best for themselves or some other constituency.

The responsibility of our board--a responsibility which I expect them to fulfill--is to ensure legal and ethical conduct by the company and by everyone in the company ... What a CEO really expects from a board is good advice and counsel, both of which will make the company stronger and more successful; support for those investments and decisions that serve the interests of the company and its stakeholders; and warnings in those cases in which investments and decisions are not beneficial to the company and its stakeholders.¹²

Ironically enough, those were the comments of then-Enron CEO Kenneth Lay in April 1999. On paper, the company's corporate governance practices met many standards of the time: the audit and compliance committee and the finance committees met frequently, and the board included a Stanford University professor of accounting, a retired United Kingdom secretary of state for energy, and the chairman of Alliance Capital, one of the largest institutional money management firms in the United States. Despite these credentials and Lay's stated commitment to exemplary corporate governance principles, the Enron board failed to meet its responsibilities as an effective monitor of management.

In contrast, other boards with less apparent independence have been able to act more effectively. Although Freddie

Mac's 18-member board contained several directors whose "resume independence" was questionable because they were previously employed at firms that enjoyed substantial business relationships with the company or were political appointees, as part of a board investigation into accounting irregularities the Freddie Mac board quite rapidly ousted the company's president, CEO and CFO, an unanticipated action lauded by corporate governance advocates. In the words of Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware, "[g]iven the [business] relationships and the political connections, the board would seem to be an unlikely candidate for quick action."¹³

The composition of the "ideal" board for optimal monitoring is not clear. The appointment of independent directors with adequate financial expertise and the endorsement of other governance best practices can be steps in the right direction, but by no means assure a board that will provide effective oversight. "C]hanges in [board] structure and process alone ... will never fully accomplish ... [needed] enhancements in corporate responsibility."¹⁴ Though helpful as starting points, these prescriptions for improved governance cannot supply directors with the motivation to *act* objectively and independently, an element that is critical to the development of an effective system of corporate governance. As corporate governance is more closely scrutinized and better understood, structural solutions like populating board committees with directors who satisfy a standard of "independence" will be less important than evidence that the board members have the expertise, the energy and the opportunity to represent the interests of the shareholders.¹⁵

[3] Efforts to Increase the Effectiveness of Boards as Corporate Monitors May Produce Only Marginal Improvements

Significant requirements for directors were put in place with the enactment of Sarbanes-Oxley, the adoption of corporate governance listing standards by the NYSE and NASDAQ, and the heightened judicial scrutiny of the duty of good faith. Among other things, today directors are asked to work harder, be more conscientious and avoid a wider variety of potential conflicts of interest. Directors meet more frequently and face increased potential liability for errors. At the end of the day, the underlying goal is that the imposition of these requirements will result in substantial improvements in corporate stewardship. However, this enhancement is merely a hope, not a certainty. And some critics believe there is a limit to the ability of directors to be "independent" as long as they are selected by management; however, this criticism is tempered somewhat at NYSE- and NASDAQ-listed companies, where directors are required to be recommended or appointed by nominating committees composed of independent directors.

Despite regulatory efforts to increase board quality, responsibility and effectiveness, directors may become only marginally better at monitoring fraud and protecting shareholder interests. For one thing, directors may not be the best agents for monitoring corporate fraud, as this kind of wrongdoing can be difficult for an outside director to detect, and it is neither feasible nor desirable for directors to become involved in the minutiae of comprehensively managing the company, as they do not have sufficient time or resources to do so effectively. As directors cannot be expected to have knowledge of all aspects of the company's activity, they will necessarily rely to a considerable extent on information provided to them by senior corporate officers. Accordingly, "[d]irectors cannot guarantee corporate compliance; they can only be expected to undertake and execute good faith efforts to ensure that it occurs."¹⁶ In fact, perpetrators of corporate fraud often are discovered not through director scrutiny, but rather through anonymous tips from internal whistleblowers.¹⁷ Rather than being ace fraud detectives, in general the outside directors on corporate boards are better suited to ask hard questions, assure that the company is following a strategic plan that makes sense, maintain discipline and insist on proper analysis. It is worth considering whether corporate governance regulation has placed too much hope in the ability of outside directors, whose involvement with the company is unlikely to extend more than a relatively small number of days each year, to provide more than broad oversight of management.

[4] Effective Monitoring Will Also Require Active and Informed Shareholders

Though the Sarbanes-Oxley Act and other regulatory efforts to enhance corporate governance are geared toward policing the "supply" side--promulgating rules and standards of conduct for lawyers, accountants, the board of directors

and management--shareholders on the "demand" side of the equation play an equally important, though less regulated, role. In the opinion of many commentators, shareholders, particularly large institutional investors, deserve some of the blame for the recent proliferation of corporate excess and scandal as they have re-elected directors of poorly performing companies, failed to challenge outrageous executive pay plans and been otherwise lax in their monitoring of the companies in which they invest.ⁿ¹⁸

The role of directors is to perform an agency function for shareholders, overseeing and protecting shareholder investments in the company. Efforts to more closely align shareholder and director interests, by, for example, requiring directors to hold a minimum amount of equity in the company, are meant to encourage and facilitate the agency role. However, as the principals, shareholders must recognize that no agent will be a perfect monitor. Shareholders must share the responsibility to effectively oversee management, taking the initiative to become informed and aware of corporate matters in order to protect their own investments. In voting their shares, shareholders cannot simply rely on their agents to act as a kind of "proxy monitor." Rather, shareholders must read the company's disclosures in the proxy statement themselves. In the words of Susan Wyderko, the SEC's former Director of Investor Education, "[i]nvesting isn't a spectator sport. If an investor isn't prepared to read a company's filings, and is still willing to purchase the stock, they've taken on additional risk."ⁿ¹⁹

Even as directors may become at least marginally more effective at corporate oversight under the encouragement of the many regulatory efforts to improve corporate governance, the investing public may be somewhat less likely to rely solely on improved board vigilance. Among other things, it is likely that shareholders, particularly institutional investors with holdings substantial enough to force corporate change and mutual fund managers who must report on their voting policies and actions, will become more actively and directly involved in corporate governance.

To the extent that shareholders take a more active role in corporate governance, for example, through the ability to nominate directors in company proxy statements and the ability to approve or disapprove executive compensation through say on pay, they are likely to come under additional scrutiny. For example, a recent law review article argues that corporate law should adapt to the current trend toward greater shareholder participation by applying the rules of fiduciary duty traditionally applicable to officers and directors to certain shareholders as well.ⁿ²⁰ Similarly, the International Corporate Governance Network has published a Statement of Principles on Institutional Shareholder Responsibilities, which states that "The ownership of equity carries important responsibilities, particularly due to the voting rights that can influence the way in which a business is conducted."ⁿ²¹

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities

FOOTNOTES:

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(n6)Footnote 6. Berkshire Hathaway Inc. 2002 Annual Report (2003).

(n7)Footnote 7. See House Committee on Financial Services, *The Sarbanes-Oxley Act: The First Year* (2003) (quoting Terry Gallagher, CEO of Corporate Governance Associates and former Vice President-Corporate Governance of Pfizer Inc.).

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(n10)Footnote 10. David Henry et al, *The Boss On The Sidelines--How auditors, directors and lawyers are asserting their power*, *Bus. Wk.*, April. 25, 2005 at 86.

(n11)Footnote 11. Roberta S. Karmel, *Splitting the CEO and Chairman*, *N.Y.L.J.*, Vol. 231, (Dec. 23, 2004). For further discussion of executive sessions, see § 6.03[2] and § 7.08 below .

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(n14)Footnote 14. Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003), *59 Bus. Law. 145 (2003)*, available at www.abanet.org/buslaw/corporateresponsibility/final_report.pdf.

(n15)Footnote 15. See Nell Minow, *The Market, Not the Law, Will Correct the Problems of Governance*, *Pub. Aff. Rev.* 10, 12 (2003), available at www.pac.org/pages/annual_report_2003.pdf.

(n16)Footnote 16. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, *57 Bus. Law. 1371 (2002)* (*emphasis omitted*). See also comment of Joseph Cotchett, a partner in the law firm of Cotchett, Pitre, Simon & McCarthy, Breakfast Meeting of National Association of Corporate Directors, Silicon Valley Chapter, Inc., *Corporate Rip Offs--Who Watches the Watcher?* (Dec. 19, 2002) (stating that typically in cases of corporate fraud, much of the fraud goes on below the director level, and the directors don't know about it until it's too late).

(n17)Footnote 17. See comment of Kathleen Bisaccia, Branch Chief of Enforcement in the SEC's San Francisco District Office, Breakfast Meeting of National Association of Corporate Directors, Silicon Valley Chapter, Inc., *Corporate Rip Offs--Who Watches the Watcher?* (Dec. 19, 2002) (stating that the SEC typically starts an informal investigation as the result of either SEC surveillance or an anonymous tip).

(n18)Footnote 18. See Kathleen Pender, *Corporate Law Needs Tightening*, *S.F. Chron.*, July 27, 2003, at I1.

(n19)Footnote 19. Susan Wyderko, *The Color of Money: Investing in Bankrupt Companies*, *Washington Post Live Online with Michelle Singletary* (May 22, 2003), available at www.washingtonpost.com/wp-srv/liveonline/03/business/r_business_singletary052203.htm].

(n20)Footnote 20. See Iman Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Shareholders*, *60 Stan. L. Rev. 1255 (2008)*.

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CHAPTER 2 THE FUTURE OF THE CORPORATE GOVERNANCE MOVEMENT

1-2 Corporate Governance: Law and Practice § 2.09

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§ 2.09 The Financial Crisis and Corporate Governance Reforms

Companies began facing new challenges because of dramatic economic events that occurred in 2008 leading to a collapse in the credit markets. This turmoil that has catalyzed rapid reshaping of our capital and credit markets is also leading to a reshaping of the corporate governance landscape as the Obama Administration and Congress move forward to address the liquidity crisis and related problems.

Historically, corporate governance in the U.S. primarily has been the province of state law, with a limited role for federal government, which focuses mostly on disclosure and process rather than substance. When the Sarbanes-Oxley Act was enacted in 2002, issues that previously had been considered to fall under the umbrella of state corporate law began being regulated by the federal government. The recent financial crisis may be changing the dynamic even further. As demonstrated by the SEC's proxy access proposals and by the bills recently introduced by Senators Schumer, Cantwell and Durbin and Congressman Peters, discussed above, the SEC and Congress are now considering setting federal corporate governance standards rather than relying on stock exchange listing standards, state law and court decisions. Such actions, if adopted, will represent a significant alteration of state and federal responsibilities.



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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice 3.syn

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§ 3.syn Synopsis to Chapter 3: STOCKHOLDERS' RIGHTS

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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.01

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§ 3.01 Importance and Nature of the Topic

[1] Stockholder Rights as Central to the Issue of Corporate Governance

The subject of stockholders' rights stands as one of the central issues of corporate governance. The field of corporate governance is generally concerned with the rules and principles that regulate the relationships between managers, who wield day-to-day authority over the corporation, and stockholders, who are the actual owners of the corporation but who are not directly involved in management. It is precisely the separation of management and ownership, together with the use of the board of directors to mediate between the two groups that drives the need for corporate governance.ⁿ¹

Because day-to-day managers are in a natural position of power vis-a-vis absentee owners, the owners need protections. Under the contemporary corporate system, these protections fall under two general headings: (1) duties owed by the managers to the owners, and (2) affirmative rights of the stockholders. The protections in the latter category, which are the subject of this chapter, fall into three categories: (1) voting rights, (2) informational rights, and (3) economic rights, including the right to dividends (when declared) and the right to an appraisal (in connection with certain transactions).

[2] Sources of Authority for Stockholder Rights

Historically in the United States, the definition and enforcement of stockholders' rights have been primarily matters of state law, and state law remains the primary source of authority in this area. More recently, however, beginning with the advent of the federal proxy rules in 1935,ⁿ² both procedural and, to an increasing extent, substantive aspects of the law governing stockholder rights have become subject to federal regulation. The scope of federal regulation initially focused on proxy solicitations and remains primarily concerned with disclosure of material information. A final source of authority is the stock exchange listing rules, which establish requirements for corporations, including the granting of stockholder rights, as a condition of having shares listed on the exchange.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Governing Documents & Procedures Records & Inspection Rights Inspection Rights Shareholders Business & Corporate Law Corporations Shareholders Appraisal & Dissent Rights General

OverviewBusiness & Corporate LawCorporationsShareholdersMeetings & VotingGeneral OverviewBusiness & Corporate LawCorporationsShareholdersMeetings & VotingVoting SharesProxy AgreementsSecurities LawAdditional Offerings & the Securities Exchange Act of 1934ProxiesGeneral Overview

FOOTNOTES:

(n1)Footnote 1. *See* Chapter 1 *above*.

(n2)Footnote 2. *See* SEC Release No. 34-12,599 (July 7, 1976).



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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.02

AUTHOR: J. Travis Laster

§ 3.02 Stockholder Voting Rights

[1] State Law

In general, the stockholders of a corporation have the power to vote to elect the directors of a corporation, to amend the bylaws, and to vote on any matter brought before the stockholders at a meeting of stockholders.ⁿ¹ Additional voting rights may be provided in the corporation's charter, by-laws, or both.

Under applicable state law, stockholders may also have additional statutory voting rights with respect to certain extraordinary matters.ⁿ² For example, under the General Corporation Law of the State of Delaware (the "Delaware General Corporation Law"), the stockholders of a corporation have the right to vote on certain extraordinary matters including amendments to the corporation's charter, certain mergers and consolidations, any sale, lease, or exchange of all or substantially all of the assets of a corporation, and the dissolution of a corporation.ⁿ³

[a] The Election of Directors

Under Delaware law, the business and affairs of a corporation is governed by a board of directors.ⁿ⁴ Stockholders have the right to elect the directors who serve on the board of directors.ⁿ⁵ The right of stockholders to elect directors is not merely a formality, but rather "the ideological underpinning upon which the legitimacy of directorial power rests."ⁿ⁶ Generally speaking, "shareholders have only two protections against perceived inadequate business performance[: they] may sell their stock ... or they may vote to replace incumbent board members."ⁿ⁷ Not surprisingly, there are numerous statutes, rules, regulations, and judicial decisions addressing stockholder votes and the mechanics of stockholder voting.

A corporation must hold an annual meeting at which directors may be elected at least every thirteen months.ⁿ⁸ Alternatively, stockholders may act by written consent to elect directors in lieu of holding an annual meeting if the action by written consent is unanimous or if all of the directorships to which directors could be elected at an annual meeting held at the effective time of the action by consent are vacant and filled by the action.ⁿ⁹ If a corporation has not held an annual meeting and the stockholders have not acted by written consent in lieu of an annual meeting within the prior thirteen months, or if it is not possible for the corporation to convene a meeting properly within the thirteen month period, then a stockholder may file suit to compel the holding of an annual meeting.^{n9.1} At a court ordered meeting, unless the court orders otherwise, any quorum requirement in the corporation's certificate of incorporation or bylaws

will not apply, and how ever many stockholders attend, in person or by proxy, will constitute a quorum.

Delaware law does not require that the certificate of incorporation or bylaws of a corporation specify the standard that shall be used for the election of directors. In the absence of any such provision in the certificate of incorporation or bylaws specifying the standard, Section 216 of the Delaware General Corporation Law provides that plurality voting shall apply.ⁿ¹⁰ At present, a majority of public companies incorporated in Delaware employ the plurality voting standard, although there is a growing trend towards employing a majority standard.

In 2006, Section 216 of the Delaware General Corporation Law was amended to provide that a "bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors."ⁿ¹¹ This amendment was adopted largely in response to a growing number of companies that have adopted stockholder proposals replacing the default plurality standard with a requirement that directors be elected by a majority vote. Under Section 216, directors cannot change a stockholder bylaw amendment that establishes the requisite vote for director elections. The Delaware General Corporation Law does not similarly limit director authority regarding any other types of bylaws, implying that directors may amend any stockholder-adopted bylaws addressing other issues.

The board of directors can be staggered into one, two or three different classes. A staggered board must be authorized in the company's certificate of incorporation, its initial bylaws, or a stockholder-adopted bylaw.ⁿ¹² Only one class of directors will stand for reelection at each annual meeting for the election of directors. A staggered board provision typically will provide that the total number of director seats shall be allocated as evenly as possible among the different classes. Directors on a staggered board only can be removed for cause, unless the certificate of incorporation provides that they can be removed without cause. Directors on a board that is not staggered can be removed with or without cause. A certificate of incorporation also can grant specific rights to a certain class or series of stock to elect directors.ⁿ¹³ The terms and voting powers of these directors may be greater or lesser than any other class of directors.

[b] Bylaw Amendments

Section 109(a) of the Delaware General Corporation Law provides that "[a]fter a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote."ⁿ¹⁴ Delaware law permits the certificate of incorporation of a Delaware corporation to confer the power to adopt, amend or repeal bylaws on the board of directors. Thus, the power to amend bylaws lies exclusively with the stockholders unless the certificate of incorporation grants concurrent authority to the board of directors.ⁿ¹⁵ At present, an overwhelming majority of public companies incorporated in Delaware have conferred this power on the board of directors, and thus the stockholders and the board of directors each have the power to adopt, amend, or repeal bylaws.

[c] Charter Amendments

Under Delaware law, stockholders generally have the right to vote on any amendment to the corporation's certificate of incorporation. After a corporation has received payment for its stock, an amendment of its certificate of incorporation is permitted only in accordance with Section 242 of the Delaware General Corporation Law.ⁿ¹⁶ Under Section 242, a potential amendment first must be approved by the board of directors in a resolution setting forth the proposed amendment, declaring its advisability, and submitting it to the stockholders entitled to vote on approval of the amendment.ⁿ¹⁷ The proposed amendment then must be submitted to a vote of stockholders at the next annual meeting or at a special meeting called for the purpose of considering the amendment.ⁿ¹⁸ Alternatively, stockholders may adopt the amendment through the exercise of written consent.ⁿ¹⁹ Prior to stockholder approval, the corporation must provide the stockholders with written notice of the board's proposed amendment.ⁿ²⁰ The notice must set forth the full text of the amendment, or summarize the changes it will make.ⁿ²¹ The notice should also state that the board has declared adoption of the amendment to be advisable.ⁿ²²

The right of stockholders to vote on a charter amendment is conditioned on prior board action. Stated differently, stockholders may not validly adopt by written consent or vote to approve an amendment that was not first duly adopted by the board of directors.ⁿ²³

Absent a provision in the certificate of incorporation requiring supermajority approval, stockholder votes (or written consents) representing a simple majority of all outstanding stock (*i.e.* 50 percent + 1 share) will then suffice to approve the amendment.ⁿ²⁴ Additionally, approval by a simple majority of particular classes of stock (or particular series within a class) is necessary when the proposed amendment will alter the number of shares in that class or series,ⁿ²⁵ alter their par value, or will adversely affect "the powers, preferences, or special rights" of the shares of such class or series.ⁿ²⁶ A class vote is not required, however, when the holders of a class or series are only indirectly harmed by a proposed amendment, without any actual change of the terms or powers of the class.ⁿ²⁷ And, under the doctrine of independent legal significance, amendments that are incidental to a merger that has been duly approved by a majority of all outstanding shares need not be put to a separate class vote.ⁿ²⁸

[d] Consolidations or Mergers

Under Delaware law, stockholders generally have the right to vote on consolidations or mergers. As with the process for amending the certificate of incorporation, the right of stockholders to vote is dependent on prior board action: a formal stockholder decision regarding a merger or consolidation can take place only after the board of directors has already deliberated, approved and declared the advisability of the proposed transaction.ⁿ²⁹ Once the board has approved and declared its advisability, the merger agreement is then submitted to the stockholders for their rejection or approval.ⁿ³⁰ As with proposed charter amendments, the stockholders may vote on the board's recommended merger agreement at an annual or special meeting called for that purpose, or through the exercise of written consent.ⁿ³¹ Absent a supermajority provision in the certificate of incorporation, the merger will then be approved by a simple majority of all outstanding shares entitled to vote.ⁿ³² Unlike charter amendments,ⁿ³³ mergers are never subject to the approval of a majority of a particular class or series of shares, unless the certificate of incorporation specifically provides otherwise.ⁿ³⁴

Where a stockholder vote on the merger is to take place at an annual or special meeting, the stockholders are entitled to at least 20 days notice of the meeting. The notice must contain either the complete text or a summary of the merger agreement.ⁿ³⁵ In addition, the federal securities laws require that a proxy statement disseminated to stockholders advance of the meeting specify the reasons for engaging in the merger, the percentage vote required for approval, and the stockholders' appraisal rights, if any, under applicable law.ⁿ³⁶ Similar requirements will apply where stockholders act by written consent.ⁿ³⁷

No stockholder vote is required, and the board of directors may act unilaterally to effect a merger or consolidation, where certain conditions are met that suggest the transaction presents minimal dangers to stockholder interests.ⁿ³⁸ Specifically, a vote of the stockholders of a corporation surviving the merger is not required if all three of the following conditions are met: (i) the agreement of merger does not amend the certificate of incorporation of the surviving corporation in any respect; (ii) each share of stock of the surviving corporation outstanding immediately prior to the effective date of the merger continues to be an identical outstanding or treasury share of the corporation; and (iii) the amount of authorized and unissued shares and treasury shares of common stock and securities convertible into common stock to be delivered in the merger do not exceed 20 percent of the amount of shares of common stock of the surviving corporation outstanding immediately before to the merger.ⁿ³⁹ In addition, no stockholder vote is required if the corporation has no outstanding stock when the directors approve the merger agreement, but later issues stock.ⁿ⁴⁰

Finally, under Section 253 of the Delaware General Corporation Law, stockholders of a parent corporation generally will not be entitled to vote on a "short form merger" between the parent and a subsidiary corporation in which the parent owns at least 90% of the outstanding shares of each class of the stock of the subsidiary. Stockholders of the parent corporation may be entitled to vote, however, if the parent corporation does not survive the merger.ⁿ⁴¹ As in the case of a "long form merger," notice must be given at least 20 days before the parent's meeting of stockholders and the merger

must be approved by the holders of a majority of the shares entitled to vote. The same considerations should apply to a meeting of the parent's stockholders as apply to a meeting of the stockholders of a constituent corporation involved in a "long form merger." If the parent is not incorporated in Delaware, the approval of its stockholders must be obtained in accordance with the requirements of the jurisdiction in which it is incorporated.

[e] Sale, Lease, or Exchange of All or Substantially All Assets

Under Section 271 of the Delaware General Corporation Law, stockholders have the right to vote on any proposal by the corporation to convey "all or substantially all" of its assets. As with the process for amending the certificate of incorporation and with votes on mergers or consolidations, the right of stockholders to vote is dependent on prior board action. First, the proposed transaction must be approved by the board of directors. Second, the proposed transaction must be approved by the holders of a majority of the outstanding voting stock either at a meeting called for such purpose or by written consent.ⁿ⁴²

Stockholders must be given notice at least 20 days prior to the meeting at which the resolution to authorize the sale of "all or substantially all" of the corporation's property and assets will be considered.ⁿ⁴³

[f] Dissolution

Dissolution is the process of terminating the legal existence of a corporation, along with its attendant relationships, rights and duties.ⁿ⁴⁴ Stockholders have the power to dissolve the corporation, without regard to the wishes of any non-stockholder directors, officers, employees, etc., in the rare event that all the stockholders entitled to vote on the issue of dissolution consent in writing.ⁿ⁴⁵ Otherwise, the board of directors must adopt a resolution proposing a dissolution, which then must be approved by the holders of a majority of all outstanding shares entitled to vote.ⁿ⁴⁶ The board's resolution may reserve discretion to abandon the dissolution without regard to the wishes of stockholders.ⁿ⁴⁷ The dissolution is effective, and the corporation is deemed dissolved, upon the filing of a certificate of dissolution with the Secretary of State.ⁿ⁴⁸

For three years after the filing of the certificate of dissolution, the corporate existence will continue for the limited purposes of "prosecuting and defending suits ... enabling [corporations] gradually to settle and close their business, to dispose of and convey their property, to discharge their liabilities and to distribute to their stockholders any remaining assets."ⁿ⁴⁹ During such period, the corporation has no power to "continu[e] the business for which the corporation was organized."ⁿ⁵⁰ Rather, it may only conduct business incidental to dissolution, such as hiring counsel to defend against suits,ⁿ⁵¹ and to reasonably employ others to help in the liquidation and distribution of corporate assets.ⁿ⁵²

Because dissolution ends the ability of the corporation to engage in normal business, stockholders lose most of their rights relating to their interest in maximizing the value of investment.ⁿ⁵³ Stockholders retain only a property interest in their pro rata share of the residual assets of the corporation.ⁿ⁵⁴

During the three-year statutory wind-up period, a corporation may revoke its dissolution.ⁿ⁵⁵ In order to revoke dissolution, the board of directors must adopt a resolution recommending that the dissolution be revoked and submit the resolution to a vote of the stockholders.ⁿ⁵⁶ Dissolution will be revoked if the holders of a majority of the shares outstanding at the time of the dissolution so approve.ⁿ⁵⁷

[g] Special Voting Rights and Preferred Stock

In addition to the voting rights granted under Delaware law, the certificate of incorporation or bylaws of a corporation may confer additional voting rights on stockholders or on certain classes or series of stock. A common example of special voting rights are those conferred on classes or series of preferred stock. Like the other rights and preferences of a particular class or series of preferred stock, special voting rights must be clearly and expressly stated in the certificate of

incorporation.ⁿ⁵⁸ These rights are "essentially contractual" and therefore are interpreted under applicable principles of contract law.ⁿ⁵⁹ A court will not presume any preferred stock rights in addition to those that are expressly stated in the certificate of incorporation.ⁿ⁶⁰ Applying these principles, courts have held that express requirements for a separate vote in the event of adverse changes to rights or preferences of preferred stock or to the company's governing documents do not apply when the cause of such change(s) is a merger.ⁿ⁶¹ This seemingly narrow interpretation is based on the presumption that holders of preferred stock acquire their shares with knowledge that, under numerous cases applying the doctrine of independent legal significance, their rights are subject to defeasance in the event of a merger complying with the applicable statute.ⁿ⁶²

The case of *Elliot Associates, L.P. v. Avatex Corp.*,ⁿ⁶³ demonstrates the importance of the specific language used in a certificate of incorporation. There, the Supreme Court of Delaware interpreted a charter provision which stated that the consent of two-thirds of the preferred stockholders "voting separately as a class" was necessary to permit any "amendment, alteration or repeal [of the company charter], ... by merger, consolidation or otherwise ... which would materially and adversely affect any right, preference, privilege or voting power of" the preferred stock.ⁿ⁶⁴ The defendants argued that its charter would not be amended in the merger, but would be nullified and replaced by the charter of its merger partner.ⁿ⁶⁵ The court held that the words "amendment, alteration or repeal" suggested an intent to include situations where a certificate of incorporation is displaced or substituted by a merger partner's charter, or by an entirely new certificate of incorporation.ⁿ⁶⁶ It based this conclusion, in part, on the use of the word "consolidation," which suggests an intent to allow voting rights in situations where none of the original entities survive and their charters are nullified.ⁿ⁶⁷ The court also held that the preferred stock would be "materially and adversely" affected because the merger would render the company charter--the source of the preferred stocks' rights--a legal nullity.ⁿ⁶⁸

[2] Stock Exchange Rules

Stockholders may also receive the right to vote on certain matters by virtue of a corporation being subject to the rules of a stock exchange on which the corporation's shares are listed. In general, the rules of the NYSE and the NASDAQ require a stockholder vote with respect to equity compensation plans and with respect to certain share issuances.ⁿ⁶⁹

In 2003, the SEC approved rule changes significantly broadening the stockholder approval requirements for equity compensation plans.ⁿ⁷⁰ Under these rules, an equity compensation plan is defined as a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services, including a compensatory grant of options or other equity securities that is not made under the plan. Certain plans or arrangements are either excluded from the definition of equity compensation plans or are exempted from the stockholder approval requirement, including the following: (i) plans that are made available to stockholders generally (such as a typical dividend reinvestment plan), (ii) plans that merely allow employees, directors, or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, (iii) employment inducement awards, (iv) certain grants, plans, and amendments in the context of mergers and acquisitions, (v) plans intended to meet the requirements of *Sections 401(a) and 423 of the Internal Revenue Code*, and (vi) certain types of pension plans within the meaning of the Employee Retirement Income Security Act.

In addition, the NYSE rules also require prior stockholder approval prior to certain share issuances.ⁿ⁷¹ For example, ordinarily, prior stockholder approval is required for share issuances by an issuer to (i) a director, officer, or substantial security holder of the company (a "Related Party"), (ii) a subsidiary, affiliate, or closely related person of a Related Party, or (iii) any company or entity in which a Related Party has a substantial direct or indirect interest, if such share issuance exceeds one percent of the total number of shares outstanding, or one percent of the voting power outstanding, of the issuer.ⁿ⁷² However, if the Related Party involved in the transaction is classified as such solely because such person is a substantial security holder, and if the issuance relates to a sale of stock for cash at a price at least as great as each of the book and market value of the issuer's common stock, then stockholder approval will not be required unless the number of shares of common stock to be issued, or unless the number of shares of common stock into which the

securities may be convertible or exercisable, exceeds either five percent of the number of shares of common stock or five percent of the voting power outstanding before the issuance."ⁿ⁷³

A stockholder vote may also be required prior to a share issuance constituting 20 percent or more of the total number of shares outstanding, or 20 percent or more of the voting power outstanding, of the issuer before the issuance of the stock.ⁿ⁷⁴ There are a number of exceptions to this general rule. Stockholder approval is not required for any such issuance involving:

- any public offering for cash;
- any bona fide private financing, if such financing involves a sale of:
 - common stock, for cash, at a price at least as great as each of the book and market value of the issuer's common stock; or
 - securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's common stock. Likewise, a stockholder vote may be required prior to a share issuance that will result in a change of control of the issuer.ⁿ⁷⁵

NASDAQ also requires a stockholder vote for certain equity compensation plans. As with the NYSE rules, the NASDAQ rules with respect to equity compensation plans were revised in 2003 to broaden significantly the stockholder approval requirements.ⁿ⁷⁶ The new NASDAQ rules are now substantially similar to the NYSE rules in this regard.

NASDAQ also requires a stockholder vote for certain share issuances. For example, a stockholder vote is required for a share issuance that will result in a change of control.ⁿ⁷⁷ A stockholder vote is also generally required for a share issuance, other than a public offering, involving the issuance of 20 percent or more of the common stock (or securities convertible into common stock) outstanding, or 20 percent or more of the voting power outstanding, of the issuer before the issuance (or if the sale or issuance is at less than the greater of market and book value and, together with sales by directors, officers, or substantial shareholders, it amounts to 20 percent or more of the common stock (or securities convertible into common stock) outstanding, or 20 percent or more of the voting power outstanding, of the issuer before the issuance).ⁿ⁷⁸

In addition, an issuer must obtain a stockholder approval vote for the issuance of common stock (or securities convertible into common stock) in connection with the acquisition of the stock or assets of another company:

- (i) if any director, officer, or substantial stockholder of the issuer has a five percent or greater interest (or such persons collectively have a ten percent or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in an increase in outstanding common shares or voting power of five percent or more; or
- (ii) where, due to the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, other than a public offering for cash--
 - (a) the common stock has or will have upon issuance voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance of stock or securities convertible into or exercisable for common stock; or

(b) the number of shares of common stock to be issued is or will be equal to or in excess of 20 percent of the number of shares or common stock outstanding before the issuance of the stock or securities.ⁿ⁷⁹

As with the NYSE rules, these requirements are subject to certain exceptions.ⁿ⁸⁰ A company relying on this exception must mail to all stockholders not later than 10 days before issuance of the securities a letter notifying them of its decision not to seek the stockholder approval that would otherwise be required and indicating that the audit committee or a comparable body of the board of directors has expressly approved the exception. Rules of other self-regulatory organizations that apply to a particular corporation may also require a stockholder vote for certain matters.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares General Overview Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares Director Elections & Removals Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares Fundamental Changes Mergers & Acquisitions Law Mergers Duties & Liabilities of Shareholders Mergers & Acquisitions Law Sales of Assets Duties & Liabilities of Shareholders

FOOTNOTES:

(n1)Footnote 1. *Del. Code Ann. tit. 8, § 211*; 2 Model Bus. Corp. Act §§ 8.03, 8.04 (3d ed. 2002).

(n2)Footnote 2. As the State of Delaware is the domicile of choice for many public corporations, the discussion of state law aspects of shareholders' rights in this chapter will focus primarily on Delaware law. The Model Business Corporation Act, upon which many states have modeled their corporation laws, also requires a stockholder vote for similar extraordinary matters. 2 Model Bus. Corp. Act §§ 8.03, 8.04 (3d ed. 2002) (electing directors); 2 Model Bus. Corp. Act § 8.10 (3d ed. 2002) (filling certain vacancies); 3 Model Bus. Corp. Act §§ 10.03, 10.04 (3d ed. 2002) (amending charter); 3 Model Bus. Corp. Act § 12.02 (3d ed. 2002) (disposing of certain assets); 3 Model Bus. Corp. Act § 14.02 (3d ed. 2002) (dissolving the corporation); 3 Model Bus. Corp. Act § 11.04 (3d ed. 2002) (merging). *See generally* Drexler et al., *Delaware Corporation Law and Practice* (LexisNexis Matthew Bender).

(n3)Footnote 3. Stockholders may also have voting rights in certain circumstances, such as when a vote of stockholders is sought to exempt a business combination from Delaware's hostile takeover statute, *Del. Code Ann. tit. 8, § 203*, or when a corporation has no directors in office and a special meeting for the election of directors is called, *Del. Code Ann. tit. 8, § 223*.

(n4)Footnote 4. *Del. Code Ann. tit. 8, § 141(a)*.

(n5)Footnote 5. *Del. Code Ann. tit. 8, § 211(b)*.

(n6)Footnote 6. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660 (Del. Ch. 1988).

(n7)Footnote 7. *Blasius*, 564 A.2d at 659.

(n8)Footnote 8. *Del. Code Ann. tit. 8, § 211(c)*. In *Hoschett v. TSI Int'l Software, Ltd.*, 683 A.2d 43, 44-45 (Del. Ch. 1996), the Delaware Court of Chancery highlighted the importance of stockholder meetings for the election of directors:

Delaware courts have long recognized the central role of annual meetings in the scheme of corporate governance. Even the shareholders' power to approve amendments to the charter does not extend so far as to permit a Delaware corporation legitimately to dispense with the annual meeting. The critical importance of shareholder voting both to the theory and to the reality of corporate governance, may be

thought to justify the mandatory nature of the obligation to call and hold an annual meeting.

Id. at 44-45 (citations omitted).

(n9)Footnote 9. *Del. Code Ann. tit. 8, § 211(b)*.

(n10)Footnote 9.1. *Del Code Ann. tit. 8, § 211(c)*; see *MFC Bancorp Ltd. v. Equidyne Corp.*, 844 A.2d 1015 (Del. Ch. 2003) .

(n11)Footnote 10. *Del. Code Ann. tit. 8, § 216*.

(n12)Footnote 11. *Del. Code Ann. Tit. 8, § 216*.

(n13)Footnote 12. *Del. Code Ann. Tit. 8, § 141(d)*.

(n14)Footnote 13. *Del. Code Ann. Tit. 8, § 141(d)*.

(n15)Footnote 14. *Del. Code Ann. tit. 8, § 109(a)*.

(n16)Footnote 15. See, e.g., *Lions Gate Entm't Corp. v. Image Entm't, Inc.*, (Del. Ch. June 5, 2006) .

(n17)Footnote 16. *Del. Code Ann. tit. 8, § 242*. See Drexler et al., *Delaware Corporation Law and Practice*, § 32.04 (LexisNexis Matthew Bender). Charter amendments prior to receipt of payment for stock must be made in accordance with Section 241 of the Delaware General Corporation Law. See Drexler et al., *Delaware Corporation Law and Practice*, § 32.03 (LexisNexis Matthew Bender).

(n18)Footnote 17. *Del. Code Ann. tit. 8, § 242(b)(1)*; see , *Martin Marietta Corp. v. Bendix Corp.*, CA 6942, 1982 Del. Ch. LEXIS 535, *12 (Sept. 19, 1982) .

(n19)Footnote 18. *Del. Code Ann. tit. 8, § 242(b)(1)*; see, e.g., 3 Model Bus. Corp. Act §§ 10.03, 10.04 (3d ed. 2002).

(n20)Footnote 19. *Del. Code Ann. tit. 8, § 228*; see § 3.06[2], below.

(n21)Footnote 20. See, generally, *Del. Code Ann. tit. 8, § 222* (providing the notice requirements for matters that stockholders are permitted to act upon at a meeting).

(n22)Footnote 21. See *Del. Code Ann. tit. 8, § 242(b)(1)*.

(n23)Footnote 22. See *Stroud v. Grace*, 606 A.2d 75, 87 (Del. 1992) .

(n24)Footnote 23. See, e.g., *Williams v. Geier*, 671 A.2d 1368, 1381 (Del. 1996) ; *AGR Halifax Fund, Inc. v. Fiscina*, 743 A.2d 1188, 1995 (Del. Ch. 1999) .

(n25)Footnote 24. See *Del. Code Ann. tit 8, §§ 242(b)(1) and (4)*.

(n26)Footnote 25. A corporation may alter the number of shares of a class or series with a simple majority vote of all shares, without obtaining the separate approval of a majority of the shares of such class or series, if the original certificate of incorporation or prior amendments which either created the affected class or series, or were approved by the affected class or series, so provide. See *Del. Code Ann. tit. 8, § 242(b)(2)*.

(n27)Footnote 26. See *Del. Code Ann. tit. 8, § 242(b)(2)*.

(n28)Footnote 27. *See, e.g., Benchmark Capital Partners IV, L.P. v. Vague, CA 19719, 2002 Del. Ch. LEXIS 90*, **51-52 & n.55 (July 15, 2002) (summarizing cases that support that a charter amendment in connection with an issuance of shares with priority or rights superior to that of a particular class does not require class vote).

(n29)Footnote 28. *See, e.g., Warner Communications, Inc. v. Chris-Craft Indus., Inc., 583 A.2d 962, 969-70 (Del. Ch. 1989)*, *aff'd*, 567 A.2d 419 (Del. 1989). The majority of shares in a particular class will have the power to vote separately on a merger only when the certificate of incorporation clearly provides that right. *See Warner Communications, 583 A.2d at 969-70*.

(n30)Footnote 29. *See Del. Code Ann. tit. 8, § 251* (requiring that, in a merger between two Delaware corporations, the board of each corporation approve and declare the advisability of entering into a merger agreement, stating certain important terms, prior to submitting the agreement to a vote of stockholders); § 252 (requiring that the § 251 process be followed by Delaware corporations merging with foreign corporations); *see also Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985)* (discussing fiduciary duty of directors to act with due care in adopting merger agreement prior to submitting it to stockholders); *accord*, 3 Model Bus. Corp. Act § 11.04 (3d ed. 2002).

(n31)Footnote 30. *See Del. Code Ann. tit. 8, § 251(c)*. *See Drexler et al., Delaware Corporation Law and Practice, § 35.04[2]* (LexisNexis Matthew Bender).

(n32)Footnote 31. *See Del. Code Ann. tit. 8, § 251(c)*; *see also Del. Code Ann. tit. 8, § 228*.

(n33)Footnote 32. *See Del. Code Ann. tit. 8, § 251(c)*.

(n34)Footnote 33. *See § 3.02[1][a] above*.

(n35)Footnote 34. *See, e.g., In re GM Class H Shareholders Litig., 734 A.2d 611, 615-16 (Del. Ch. 1999)*; *see also Warner Communications, 583 A.2d 962*.

(n36)Footnote 35. *See Del. Code Ann. tit. 8, § 251(c)*.

(n37)Footnote 36. *See 17 C.F.R. § 240.14(a)-101 at Item 14(b)(4)*; *see also 17 C.F.R. § 229.1004*.

(n38)Footnote 37. *See 17 C.F.R. § 240.14(c)-2*.

(n39)Footnote 38. *See generally Ward et al., Folk on the Delaware General Corporation Law, § 251.2.2.1 (2003 Supp.)*

(n40)Footnote 39. *See Del. Code Ann. tit. 8, § 251(f)*. Note that subsection (iii) permits a corporation to issue any amount of shares of non-convertible preferred stock without a stockholder vote. *See Ward et al., Folk on the Delaware General Corporation Law, § 251.2.2.1 (2003 Supp.)*

(n41)Footnote 40. *See Del. Code Ann. tit. 8, § 251(f)*.

(n42)Footnote 41. A "short form merger" is a procedure by which a parent corporation may merge with a subsidiary if the parent owns at least 90 percent of each class of the subsidiary's outstanding shares. In general, a short form merger can be effected without any vote of stockholders.

(n43)Footnote 42. *Del. Code Ann. tit. 8, § 271*. *See, e.g., 3 Model Bus. Corp. Act § 12.02 (3d ed. 2002)*.

(n44)Footnote 43. *Del. Code Ann. tit. 8, § 271(a)*. In counting the 20 day period, the date of mailing should be excluded and the date of the meeting should be included. *See Santow v. Ullman, 39 Del. Ch. 427, 166 A.2d 135 (Del. 1960)*. In *Auerbach v. Earth Energy Sys., Inc., CA 8568, 1986 Del. Ch. LEXIS 448, at *12-13 (Aug. 19, 1986)*, the court found that the execution of a written consent by the holder of 74 percent of the outstanding voting stock cured the

failure to give proper notice to the stockholders pursuant to Section 271.

(n45)Footnote 44. At common law, dissolution of the corporation abruptly ended its legal existence, extinguishing any claims by or against the corporation. *See In re Citadel Indus., Inc.*, 423 A.2d 500, 503 (Del. Ch. 1980) . Courts developed the "trust fund doctrine" under which its property would then be administered in equity for the benefit of creditors. *See Bovay v. H. M. Byllesby & Co.*, 27 Del. Ch. 381, 38 A.2d 808, 813 (Del. 1944) ; *see generally* Fletcher's Cyclopedia of Corporations § 8130 at 252 (2002 Supp.). Modern statutes pertaining to dissolution temporarily extend the corporate existence, and its attendant legal relationships for the purpose of performing acts to facilitate a more orderly termination. *See, e.g., Del. Code Ann. tit. 8, §§ 273-285.*

(n46)Footnote 45. *Del. Code Ann. tit. 8, § 275(c)*. *See generally* Drexler et al., *Delaware Corporation Law and Practice*, §§ 38.01-38.08 (LexisNexis Matthew Bender) (discussion of dissolution and winding up of Delaware corporation).

(n47)Footnote 46. *Del. Code Ann., tit. 8, §§ 275(a), (b)*.

(n48)Footnote 47. *Del. Code Ann. tit. 8, § 275(e)*.

(n49)Footnote 48. *Del. Code Ann. tit. 8, § 275(f)*.

(n50)Footnote 49. *Del. Code Ann. tit. 8, § 278*.

(n51)Footnote 50. *See Del. Code Ann. tit. 8, § 278*; *see also Gamble v. Penn. Val. Crude Oil Corp.*, 34 Del. Ch. 359, 104 A.2d 257, 260 (Del. Ch. 1954) (stating "a dissolved Delaware corporation has the power to close its affairs but not to carry on the business for which it was established.")

(n52)Footnote 51. *See Ross v. Venezuelan-American Indep. Oil Producers Ass'n.*, 230 F. Supp. 701, 702 (D. Del. 1964) (holding attorneys' retainer agreement entered into within three-year winding up period was enforceable against corporation).

(n53)Footnote 52. *See, e.g., McBride v. Murphy*, 14 Del. Ch. 242, 124 A. 798, 801 (Del. Ch. 1924) , *aff'd* 14 Del. Ch. 457, 130 A. 283 (Del. 1925) (holding dissolved corporation lacked power to take property under a will, reasoning that in contrast to the power to obtain property, corporation had the power to dispose of its property, as this was "incidental and necessary to the delegated power to wind up.")

(n54)Footnote 53. *See, e.g., Willard v. Harrworth Corp.*, 267 A.2d 577 (Del. 1970) (holding that a stockholder of dissolved corporation loses right to inspect corporate books and records).

(n55)Footnote 54. *See, e.g., Grover*, 642 A.2d 792, 799 n. 10 (Del. Ch. 1993)

(n56)Footnote 55. *Del. Code Ann. tit. 8, § 311*.

(n57)Footnote 56. *Del. Code Ann. tit. 8, § 311*.

(n58)Footnote 57. *Del. Code Ann. tit. 8, § 311*.

(n59)Footnote 58. *See, e.g., Benchmark Capital Partners IV, L.P. v. Vague*, 2002 Del. Ch. LEXIS 90 , at **25, 32-3 (July 15, 2002).

(n60)Footnote 59. *See Warner Communications, Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962, 969-70 , *aff'd*, 567 A.2d 419 (Del. 1089) .

(n61)Footnote 60. *See Rothschild Int'l. Corp. v. Liggett Group Inc.*, 474 A.2d 133, 136 (Del. 1984) .

(n62)Footnote 61. *See Warner Communications*, 583 A.2d at 969-70 ; *see also Sullivan Money Mgmt., Inc. v. FLS Holdings Inc.*, CA 12731, 1992 Del. Ch. LEXIS 236, at *24 (Nov. 20, 1992) , *aff'd*, 628 A.2d 84 (Del. 1993) .

(n63)Footnote 62. *See, e.g., Rothschild Int'l. Corp.*, 474 A.2d at 136-37 ; *see also Del. Code Ann. tit. 8, § 251(c)* (requiring only a simple majority of all outstanding shares to approve proposed merger; not providing for a separate class vote).

(n64)Footnote 63. *Elliot Associates, L.P. v. Avatex Corp.*, 715 A.2d 843 (Del. 1998) .

(n65)Footnote 64. *Elliot Associates*, 715 A.2d at 845 (emphasis omitted).

(n66)Footnote 65. *See Elliot Associates*, 715 A.2d at 853 .

(n67)Footnote 66. *See Elliot Associates*, 715 A.2d at 854 .

(n68)Footnote 67. *See Elliot Associates*, 715 A.2d at 850 , 853.

(n69)Footnote 68. *See Elliot Associates*, 715 A.2d at 843 .

(n70)Footnote 69. NYSE Listed Company Manual § 312 Shareholder Approval Policy; Nasdaq Rule 4350(i).

(n71)Footnote 70. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans (June 30, 2003) (adopting NYSE Listed Company Manual § 303A.08 Shareholder Approval of Equity Compensation Plans), *available at* www.sec.gov/rules/sro/34-48108.htm.

(n72)Footnote 71. NYSE Listed Company Manual § 312.03, Shareholder Approval.

(n73)Footnote 72. NYSE Listed Company Manual § 312.03(b), Shareholder Approval.

(n74)Footnote 73. NYSE Listed Company Manual § 312.03, Shareholder Approval.

(n75)Footnote 74. NYSE Listed Company Manual § 312.03(c), Shareholder Approval.

(n76)Footnote 75. NYSE Listed Company Manual § 312, Shareholder Approval Policy.

(n77)Footnote 76. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans (June 30, 2003), *available at* www.sec.gov/rules/sro/34-48108.htm.

(n78)Footnote 77. NASD Rule 4350(i)(1)(B).

(n79)Footnote 78. NASD Rule 4350(i)(1)(D).

(n80)Footnote 79. NASD Rule 4350.

(n81)Footnote 80. NASD Rule 4350(i)(2) provides that "[e]xceptions may be made upon application to NASDAQ when: (A) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise; and (B) reliance by the company on this exception is expressly approved by the audit committee or a comparable body of the board of directors."



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Corporate Governance: Law and Practice

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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.03

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§ 3.03 Informational Rights

[1] Books and Records

Under Delaware law, "any stockholder" may inspect and copy a corporation's books and records during usual business hours for any proper purpose reasonably related to the stockholder's interests as a stockholder.ⁿ¹ The right to inspect books and records extends to the books and records of subsidiaries, to the extent that the corporation has actual possession and control of such records or could obtain such records through the exercise of control over the subsidiary, as long as (A) the inspection would not violate a confidentiality agreement with any third party and (B) the subsidiary would not have the right, under applicable law, to deny the corporation access to such books and records upon demand. The term "stockholder" includes "a holder of record ... or a person who is the beneficial owner of shares of such stock held either in a voting trust or by a nominee on behalf of such person ..." and the inspection and copying may be done by the stockholder or his or her attorney or other agent.ⁿ²

To be entitled to inspect books and records, a stockholder must make a demand in writing, stating the purpose for which inspection is sought.ⁿ³ The demand should be delivered to the corporation's principal place of business, although the statute also permits delivery to the corporation's registered agent.ⁿ⁴ When an attorney or other agent seeks the right to inspection, the demand must be accompanied by a power of attorney or other writing authorizing the attorney or agent to act on behalf of the stockholder.ⁿ⁵ The demand must be made "under oath," which includes a statement by the declarant affirming that the matters are true under penalty of perjury. The demand may be notarized, but this is not required.ⁿ⁶ A high-ranking officer in a corporation can make a demand on behalf of the company.ⁿ⁷

If a corporation fails to respond to a Section 220 demand, a stockholder may seek to enforce its informational rights. A stockholder cannot commence a suit until at least five days after the company receives the demand and fails to respond.ⁿ⁸ The five-day waiting period is a jurisdictional "prerequisite" to relief.ⁿ⁹

One issue that is litigated often in Section 220 proceedings is whether the stockholder has a proper purpose for seeking inspection. A proper purpose for a stockholder is any purpose reasonably related to its interest as a stockholder.ⁿ¹⁰ Applying this standard, Delaware courts have consistently held that valuation of one's shares is a proper purpose for seeking inspection.ⁿ¹¹ This purpose is proper even where the entity at issue is a closely held corporation.ⁿ¹² Delaware

courts also have held that investigation of corporate mismanagement is a proper purpose when a stockholder alleges a credible basis to infer that mismanagement has occurred.¹³ Once a proper purpose is stated, stockholders generally will be entitled to inspect those books and records that are necessary and essential to the satisfaction of the stated purpose. When the purpose is the investigation of fiduciary misconduct, however, stockholders frequently are entitled to broader inspection rights.¹⁴

[2] Disclosure

Stockholders have a right to information in the form of disclosure under state incorporation laws, state common law doctrines, and the federal securities laws. Under the Delaware General Corporation Law, the only action that a corporation must take annually and must disclose to its stockholders is the holding of an annual meeting at which directors are elected, or the taking of action by written consent to elect directors in lieu of the annual meeting. If the corporation holds an annual meeting, then stockholders have a statutory right to receive notice of the meeting stating the date, time, and location of the meeting.¹⁵ No other information is required as a matter of statute. If directors are elected by written consent, then any non-consenting stockholders are entitled to notice of the action taken.¹⁶ Other notice requirements apply in the event the corporation chooses to hold a special meeting or pursues an extraordinary transaction, such as a merger or a sale of assets.¹⁷

Under Delaware common law, directors of a Delaware corporation have a fiduciary duty to disclose all material information to stockholders when seeking stockholder action.¹⁸ Directors of a Delaware corporation also have a fiduciary duty to speak truthfully and completely when they choose to speak, even if they are not seeking stockholder action.¹⁹ To survive a motion to dismiss a disclosure action, the shareholder's complaint must set forth "well-pleaded facts from which it can be reasonably inferred that [the omitted fact] was knowable and that the defendant was in a position to know it."²⁰ The extensive disclosure obligations imposed on public companies by the federal securities laws are beyond the scope of this chapter.²¹

Legal Topics:

For related research and practice materials, see the following legal topics:
 Business & Corporate Law Corporations Governing Documents & Procedures Records & Inspection Rights Inspection Rights Shareholders Securities Law Liability Disclosures General Overview

FOOTNOTES:

(n1)Footnote 1. *Del. Code Ann., tit. 8, § 220(b)*.

(n2)Footnote 2. *Del. Code Ann. tit. 8, § 220(a), (b)*.

(n3)Footnote 3. *Del. Code Ann., tit. 8, § 220(b); Compaq Computer Corp. v. Horton, 631 A.2d 1, 3 (Del. 1993)*.

(n4)Footnote 4. *Del. Code Ann. tit. 8, § 220(b)*.

(n5)Footnote 5. *Del. Code Ann. tit. 8, § 220(b)*. See also 1 Balotti & Finkelstein, *The Delaware Law of Corporations and Business Organizations*, § 7.43 (3d ed. 2002).

(n6)Footnote 6. *Del. Code Ann. tit. 8, § 220(a)(3)*.

(n7)Footnote 7. See *Agency Rent-A-Car, Inc. v. Gateway Indus., Inc., CA 630, 1980 Del. Ch. LEXIS 630 (July 21, 1980)* (holding that where the president and chief operating officer of the stockholder of record submitted a demand that was attested to by the assistant secretary of the stockholder, no separate power of attorney was required); *Tannetics, Inc. v. A.J. Indus., Inc., CA 4592, 1974 Del. Ch. LEXIS 118 (Sept. 4, 1974)* (holding that a president of a corporation may make a demand under oath on behalf of the corporation without submitting a separate written authorization or resolution of the board of directors).

(n8)Footnote 8. *Del. Code Ann., tit. 8, § 220(c)*. See, e.g., *Weisman v. Plains Res., Inc.*, CAs 10,814, 10,840, 1989 *Del. Ch. LEXIS 64* (June 1, 1989) ; *Levy v. Recognition Equip. Co.*, CA 6705, 1982 *Del. Ch. LEXIS 418* (Feb. 26, 1982) .

(n9)Footnote 9. *Weisman*, 1989 *Del. Ch. LEXIS 64*, at *2 .

(n10)Footnote 10. *Del. Code Ann. tit. 8, § 220(b)*; *Shaw v. Agri-Mark, Inc.*, 663 A.2d 464, 467 (Del. 1995) (purpose is proper if it is germane to the individual's interest or status as a stockholder).

(n11)Footnote 11. See *Macklowe v. Planet Hollywood, Inc.*, CA 13450, 1994 *Del. Ch. LEXIS 182* (Sept. 29, 1994) ; *Ostrow v. Bonney Forge Corp.*, CA 13270, 1994 *Del. Ch. LEXIS 39* (Apr. 6, 1994) .

(n12)Footnote 12. *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 792-93 (Del. 1982) .

(n13)Footnote 13. See, e.g., *Sec. First Corp. v. U.S. Die Casting & Dev. Co. .*, 687 A.2d 563, 567 (Del. 1997) .

(n14)Footnote 14. See, e.g., *Skoglund v. Ormand Indus., Inc.*, 372 A.2d 204, 211 (Del. Ch. 1976) .

(n15)Footnote 15. *Del. Code Ann. tit. 8, § 222(a)*.

(n16)Footnote 16. *Del. Code Ann. tit. 8, § 228(d)*.

(n17)Footnote 17. See, e.g., *Del. Code Ann. tit. 8, §§ 222(c), 251(c)*.

(n18)Footnote 18. See, e.g., *Zirn v. VLI Corp.*, 621 A.2d 773, 778 (Del. 1993) .

(n19)Footnote 19. See *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) .

(n20)Footnote 20. *Pfeffer v. Redstone*, 965 A.2d 676 (Del. 2009) (rejecting application of entire fairness scrutiny to voluntary, non-coercive offer).

(n21)Footnote 21. For discussion of disclosure obligations under the federal securities laws, see generally A.A. Sommer, Jr. (Gen. Ed.), *Federal Securities Exchange Act of 1934* (LexisNexis Matthew Bender); A.A. Sommer, Jr. (Gen. Ed.), *Securities Law Techniques* (LexisNexis Matthew Bender).



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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.04

AUTHOR: J. Travis Laster

§ 3.04 Stockholder Lists

[1] State Law

In Delaware, stockholders have the right to obtain a copy of the materials used to identify those entitled to vote at the meeting as the [corporation] itself now possesses or as may be supplemented before the annual meeting.ⁿ¹ Delaware law gives stockholders the right to inspect all of the materials reasonably available to the corporation so that stockholders will not be unfairly disadvantaged in a proxy contest or tender offer.ⁿ²

In addition to the stockholder list, under Delaware law stockholders may inspect and copy transfer sheets documenting changes of ownership subsequent to the date of the list, a magnetic computer tape containing a list of the stockholders and such computer processing data as is necessary to use the tape, a print-out of the tape for verification purposes, a listing of the brokers and institutions holding stock in street name through various depositories or nominees, and information in the company's possession concerning the identity of beneficial owners who have not objected to disclosure of their identities (a so-called NOBO list). The SEC requires that registered brokers and dealers provide companies with a list of their customers who are beneficial owners of the company's securities and who have not objected to the disclosure of that information.ⁿ³ The NOBO list is to be used only for corporate communications.ⁿ⁴ In short, Delaware law requires corporations responding to a Section 220 demand to "include all of those forms of stockholder data readily available to the corporation."ⁿ⁵

The Court of Chancery held that the purposes of Section 220 do not expressly conflict with the SEC rules regarding NOBO lists and, thus, "[w]here ... the corporation has obtained a NOBO list and is or will be using it to solicit its stockholders in connection with the annual meeting, plaintiff should be allowed the same channel of communication."ⁿ⁶ The Court of Chancery also held that plaintiffs who secure NOBO lists pursuant to a Section 220 demand are "expressly bound" by the limitations imposed on the proper use of such lists by the SEC. Nevertheless, under Delaware law, if the corporation does not already have a NOBO list, the corporation is not required to obtain such a list in response to a Section 220 demand.ⁿ⁷

Another type of stockholder list often sought by stockholders is the DTC or Cede breakdown. The Depository Trust Company ("DTC") uses the name Cede & Co. to hold shares owned by DTC in street name. DTC is "an association of

more than 200 brokerage houses and financial institutions which was formed for the purpose of owning shares held in street name for the beneficial interest of customers of the brokerage firms and financial institutions."n8 Thus, when Cede appears as a stockholder on a corporate ledger, it is "thrice removed from the true beneficial owner."n9

A Cede breakdown revealing "just which brokerage firms own shares and the number of shares owned by each ... can be provided to the corporation at its request."n10 Because a Cede breakdown may be generated in a matter of hours, Delaware courts have held such lists to be "readily available to the corporation ... and should be made available to plaintiff ... so that his list of stockholders for his proper purpose of soliciting proxies is at least equivalent, in this aspect, with the list available to the corporation for the same purpose."n11 Thus, unlike a NOBO list, under Delaware law a Cede breakdown must be made available to a stockholder upon proper demand.n12

[2] Proxy Rules

Under SEC proxy rules, a company is required to provide stockholders with a process for contacting other stockholders in two situations: (i) whenever the company itself solicits proxies and a shareholder makes a proper demand for the company to provide for the distribution of the shareholder's materials to the same stockholders; and (ii) when stockholders solicit proxies in connection with a tender offer to acquire the company's securities from existing stockholders. Generally, in both situations, the company may choose to either provide the stockholder list to the requesting stockholder or mail the requesting stockholder's soliciting or tender offer materials to other stockholders at the requesting stockholder's expense.

Under Rule 14a-7, if the issuer has made or intends to make a proxy solicitation in connection with a security holder meeting or action by consent or authorization, upon the written request by any record or beneficial holder of securities of the class entitled to vote at a meeting or to execute a consent or authorization to provide a list of security holders or to mail the requesting security holder's materials, the issuer is required, within five business days of receiving the request, to (i) notify the requesting stockholder whether it has elected to mail the soliciting materials or provide a security holder list, if the issuer is entitled to make that election (see below), (ii) state the approximate number of record and beneficial holders, separated by type of holder and class, and (iii) provide the estimated cost of mailing a proxy statement to such holders, including, to the extent reasonably known or available, the estimated costs of any bank or broker through whom the issuer intends to solicit beneficial owners in connection with the security holder meeting or action by written consent.n13

At the issuer's or security holder's option (if the matter at hand is a going-private transaction or certain type of roll-up transaction), or at the issuer's option (if the subject matter is anything else), the issuer may (a) mail copies of a proxy statement or other solicitation furnished by the requesting security holder to the record holders, including banks and brokers who are so designated by the requesting security holder, or (b) within five business days after receiving the security holder's request, provide the security holder with a reasonably current list of shareholders' securities positions of record, names, and addresses. When the issuer mails the security holder's materials, the issuer may not delay sending the material but must mail the security holder materials with reasonable promptness after receiving them, along with appropriate envelopes or other containers, postage or payment for postage, and other reasonable expenses of such mailing. The issuer is, of course, not responsible for the content of the material.n14

When the elected method is delivery of a shareholder list, the issuer must provide: (i) a reasonably current list of the names, addresses and security positions of the record holders, including banks, brokers, and similar entities holding securities in the same class or classes as holders that have been or are to be solicited on management's behalf, or any more limited group of such holders designated by the security holder if available or retrievable under the issuer's or its transfer agent's security holder data systems;n15 (ii) the most recent list of names, addresses and security positions of beneficial owners as specified in Rule 14a-13(b) (the NOBO list), in the possession, or which subsequently comes into the possession, of the issuer; and (iii) the names of security holders at a shared address that have consented to delivery of a single copy of proxy materials to a shared address, if the issuer has received written or implied consent in

accordance with Rule 14a-3(e)(1).ⁿ¹⁶ The issuer is required to provide the security holder list information in the form specified by the requesting security holder if such form is available without undue burden or expense. There is a continuing obligation to update the record holder information on a daily basis or, if not available on a daily basis, at the shortest reasonable intervals, up to the record date for the meeting or action.ⁿ¹⁷

In connection with a tender offer, a bidder may seek a stockholder list from a company under Rule 14d-5 of the Securities Exchange Act of 1934 (the "1934 Act"). The bidder must present a written request to the company identifying: (i) the identity of the bidder; (ii) the title of the class of securities which is the subject of the bidder's tender offer; (iii) a statement that the bidder is making a request to the subject company pursuant to Rule 14d-5(a) for the use of the stockholder list and security position listings for the purpose of disseminating a tender offer to security holders; (iv) a statement that the bidder is aware of and will comply with the relevant provisions of Rule 14d-5; (v) a statement as to whether or not it has elected to disseminate amendments disclosing material changes to the tender offer materials pursuant to this section; and (vi) the name, address, and telephone number of the person whom the subject company shall contact in connection with the request. Following receipt of the request, the company may choose to either complete the mailing to the stockholders for the bidder or provide the stockholder list to the bidder.ⁿ¹⁸

Rule 14(d) limits the requesting security holder's use and retention of the information discussed above:

The security holder shall not use the information furnished by the [issuer] ... for any purpose other than to solicit security holders with respect to the same meeting ... for which the [issuer] is soliciting or intends to solicit or communicate with security holders with respect to a solicitation commenced by the [issuer]; or disclose such information to any person other than an employee ... or beneficial owner for whom a request was made The security holder shall return the information ... and shall not retain any copies thereof or information derived from such information after the termination of the solicitation.ⁿ¹⁹

Rule 14(d) also requires the requesting security holder to reimburse the issuer for costs associated with the request.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Governing Documents & Procedures Records & Inspection Rights Inspection Rights Shareholders Business & Corporate Law Corporations Shareholders General Overview Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares General Overview Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares Proxy Agreements Securities Law Additional Offerings & the Securities Exchange Act of 1934 Proxies General Overview

FOOTNOTES:

(n1)Footnote 1. *Szeto v. Phoenix Laser Sys., Inc.*, CA 12,991, 1993 Del. Ch. LEXIS 104, at *4 (June 25, 1993) . See also Del. Code Ann., tit. 8, § 219 (requiring a corporation to make a list of stockholders at least 10 days before any meeting of stockholders); Del. Code Ann. tit. 8, § 220(b) (allowing shareholders to inspect and copy the stockholder list by making a proper demand under oath).

(n2)Footnote 2. *Hatleigh Corp. v. Lane Bryant, Inc.*, 428 A.2d 350, 353-54 (Del. Ch. 1981) .

(n3)Footnote 3. See SEC Rule 14(b)-1(c).

(n4)Footnote 4. See SEC Rule 14(a)-13(b)(2).

(n5)Footnote 5. *Shamrock Assoc. v. Texas Am. Energy Corp.*, 517 A.2d 658, 661 (Del. Ch. 1986) .

(n6)Footnote 6. *Shamrock Assoc.*, 517 A.2d at 661 .

(n7)Footnote 7. *See* *Envtl. Diagnostics, Inc. v. Disease Detection Int'l, Inc.*, C.A. No. 10052, mem. op. at 10, Allen, C. (Del. Ch. July 15, 1988) ("[If the company has a NOBO list] then the company has to provide it. But if the company doesn't have it, it doesn't have to provide it."). *But see* *Sadler v. NCR Corp.*, 928 F.2d 48 (2d Cir. 1991) (affirming, under New York law, order that issuer obtain a NOBO list when it did not already have one).

(n8)Footnote 8. *Giovanini v. Horizon Corp.*, CA 5961, 1979 Del. Ch. LEXIS 471, at *2 (Sept. 12, 1979) .

(n9)Footnote 9. *Giovanini*, 1979 Del. Ch. LEXIS 471, at *2 .

(n10)Footnote 10. *Giovanini*, 1979 Del. Ch. LEXIS 471, at *3 .

(n11)Footnote 11. *Giovanini*, 1979 Del. Ch. LEXIS 471, at *4-5 .

(n12)Footnote 12. *RB Assoc. of New Jersey, L.P. v. The Gillette Co.*, 1988 Del. Ch. LEXIS 40, at *17 (Mar. 22, 1988) .

(n13)Footnote 13. SEC Rule 14(a)-7(a)(1).

(n14)Footnote 14. SEC Rule 14(a)-7(2)(i).

(n15)Footnote 15. SEC Rule 14(a)-7(2)(ii).

(n16)Footnote 16. SEC Rule 14(a)-7(2)(ii).

(n17)Footnote 17. SEC Rule 14(a)-7(2)(ii).

(n18)Footnote 18. SEC Rule 14d-5.

(n19)Footnote 19. SEC Rule 14(d).



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Corporate Governance: Law and Practice

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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.05

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§ 3.05 Annual Meeting of Stockholders

[1] Basic Requirements

[a] Time and Location

As a general rule, a corporation must hold an annual meeting of stockholders for the election of directors.ⁿ¹ A narrow exception to this rule allows stockholders to act by written consent in lieu of an annual meeting in certain rare circumstances where either (i) stockholders exercise unanimous written consent, or (ii) all of the directorships to be voted upon at the annual meeting are vacant at that time and are then filled by written consent.ⁿ² Director election by written consent that is (i) non-unanimous or (ii) involves the re-election or removal and replacement of less than all sitting directors will not suffice to fulfill the annual meeting requirement.ⁿ³ Such directors will be up for re-election at the next annual meeting.ⁿ⁴

A corporation has great flexibility in determining the location and timing of its annual meeting. The corporation may choose any date and time for its annual meeting and specify the exact timing in its bylaws.ⁿ⁵ Most corporate bylaws do not designate a particular date for the annual meeting, but rather specify that it will occur on a certain day in a particular month-- *e.g.* the third Tuesday in May.ⁿ⁶ Where applicable, federal securities laws and stock exchange rules may require that the annual meeting take place after the distribution of an annual report and within a reasonable time after the close of the preceding fiscal year.ⁿ⁷ A corporation's claimed inability to prepare such materials, however, will not justify an otherwise objectionable delay in holding an annual meeting.ⁿ⁸ Similarly, the location for the annual meeting may be anywhere specified in the bylaws or certificate of incorporation.ⁿ⁹ The annual meeting need not take place within the state of incorporation.ⁿ¹⁰ If the bylaws or certificate of incorporation do not address the timing or location of the annual meeting (or expressly delegate such matters to the board of directors), the board has discretion over these matters.ⁿ¹¹ The board may decide to hold the annual meeting without any physical location, by means of remote communication devices that allow stockholders "a reasonable opportunity to participate and vote."ⁿ¹²

The failure to hold an annual meeting as scheduled has no adverse consequences for the corporation or its directors under the statutory scheme.ⁿ¹³ The mere fact that a corporation has a holdover board will not cause the dissolution of the corporation or have any affect on otherwise valid corporate actions.ⁿ¹⁴ Nevertheless, a board may not delay an annual meeting indefinitely. Any stockholder or director may petition the court to schedule an annual meeting where

more than thirty days have passed since the date specified in the bylaws or, if the bylaws do not set a date, where the last annual meeting occurred more than thirteen months before.ⁿ¹⁵ In such circumstances, the court may designate the time and place of the meeting, the record date to determine stockholders entitled to vote, and the contents of the notice for the meeting.ⁿ¹⁶ Where an annual meeting date is set by court order, otherwise applicable quorum requirements will not apply, and the number of shares actually present or represented by proxy are deemed sufficient for the conduct of business.ⁿ¹⁷ The statutory requirement of a timely annual meeting still applies where the corporation has ceased its ongoing business operations and is on the verge of liquidation.ⁿ¹⁸

Even where the timing of the annual meeting is left to directors' discretion, there are equitable limits on a boards' ability to set a meeting date. These equitable limits on directors acknowledge that the stockholder vote is "the ideological underpinning upon which the legitimacy of directorial power rests."ⁿ¹⁹ For this reason, directors' decisions in this context will be invalid when they are taken for the inequitable purpose of impairing stockholders' voting rights, unless the board can show a compelling justification for its actions.ⁿ²⁰ The result of this inquiry will depend upon whether the circumstances clearly indicate the presence of an inequitable purpose.ⁿ²¹

In *Schnell v. Chris-Craft Indus., Inc.*,ⁿ²² for example, two days after stockholders became dissatisfied with management performance and revealed their intention to wage a proxy fight to replace the incumbent directors, those same directors amended the corporate bylaws to move up the annual meeting date by one month.ⁿ²³ Corporate management had also refused to produce its list of stockholders, while hiring two proxy solicitors to help fight the dissident stockholders.ⁿ²⁴ The court held that, although the directors' bylaw amendment was in compliance with the applicable statute, it was rendered invalid by its being taken for "inequitable purposes, contrary to established principles of corporate democracy."ⁿ²⁵ The court ordered the original meeting date reinstated.ⁿ²⁶

An inequitable purpose has also been found where incumbent directors have sought to delay an annual meeting.ⁿ²⁷ In *Aprahamian v. HBO & Co.*,ⁿ²⁸ for example, incumbent directors sought to postpone a scheduled annual meeting for approximately five months.ⁿ²⁹ A month before the scheduled meeting, a group of dissident stockholders who opposed the directors' reelection and advocated a possible sale of the company began to solicit proxies from other stockholders. The day before the meeting, after the incumbent directors received reports that the election was too close to call, they decided to postpone the annual meeting and set a new record date.ⁿ³⁰ The court found that, because the directors had manipulated the election process, they bore the burden of showing that a delay would serve stockholders' significant interests.ⁿ³¹ Because the directors could not do so,ⁿ³² the court ordered that the meeting be convened in order to preserve the record date and prevent the expiration of the plaintiffs' proxies. It would then be adjourned and reconvened shortly thereafter with new notice to stockholders, who were understandably "bewildered" by the directors' sudden postponement and the ensuing litigation.ⁿ³³

On the other hand, "well-motivated, independent directors" may reschedule a special meeting within a reasonable time to consider an offer from a third-party acquirer when they believe the shareholders may reject the offer and discourage the acquirer, and want to provide more information to the shareholders before the vote.^{n33.1} Vice Chancellor Strine held that the proper standard of review is "a reasonableness standard," and that the initial burden is on the board to "identify a legitimate corporate objective served by its decision" to reschedule the meeting and "show that their motivations were proper and not selfish."^{n33.2}

In general, courts will typically uphold the directors' decision where there is no showing of objective harm to the electoral process (other than a delay).ⁿ³⁴ In particular, where no meeting date is formally set and no actual proxy contest is yet underway, a board's decision to delay holding an annual meeting will generally be upheld.ⁿ³⁵ Similarly, the courts will not presume that, during a delay, incumbent directors will breach their fiduciary duties to the detriment of the company.ⁿ³⁶

Finally, an otherwise objectionable re-scheduling of an annual meeting may be justified as being in the best interest of the corporation where the board makes an informed decision that it needs additional time to evaluate and explore

alternatives to new acquisition offers.ⁿ³⁷

[b] Adjournment of Meetings

Once a meeting is convened and underway, circumstances may arise making an adjournment desirable. Such circumstances may include facts evidencing vote fraud, the absence of a quorum, the need to count votes submitted at a meeting, or waiting for a court opinion regarding matters at issue.ⁿ³⁸ Meetings of stockholders may generally be adjourned by an authorized officer presiding at the meeting or with the approval of a majority of shares present.ⁿ³⁹ Applicable statutes or the corporation's charter or bylaws may specify the procedure for conducting and adjourning a meeting.ⁿ⁴⁰

The notice required for a meeting that is reconvened after adjournment may be determined by the company's bylaws.ⁿ⁴¹ Where the bylaws are silent, no new notice need be given for an adjourned meeting if (1) the time and place where the meeting will be reconvened are announced at the original meeting, (2) the original record date is kept, and (3) the reconvened meeting is held within 30 days.ⁿ⁴² The reconvened meeting is a continuation of the initial meeting,ⁿ⁴³ and so, if a quorum was present at the initial meeting, no quorum count is necessary at the reconvened meeting.ⁿ⁴⁴ Any business that could be conducted at the original meeting may be considered at the reconvened meeting.ⁿ⁴⁵ A quorum at the original meeting (prior to adjournment) suffices to validate action taken at a reconvened meeting even though stockholders or proxies withdraw from the meeting in the interim.ⁿ⁴⁶

As with the initial scheduling of an annual meeting,ⁿ⁴⁷ there are equitable limits on corporate officers' discretion in adjourning and reconvening a meeting. In *State of Wisconsin Inv. Board v. Peerless Sys. Corp.*,ⁿ⁴⁸ a large institutional investor challenged the decision of the company's Chairman and CEO to adjourn an annual meeting without closing the polls on a controversial proposal to add one million shares to the company's stock option plan.ⁿ⁴⁹ After receiving the company's proxy statement, the plaintiff initiated a proxy fight to defeat the proposal, emphasizing the potential dilutive impact of the issuance upon existing stockholders.ⁿ⁵⁰ At an annual meeting just over two weeks later, a majority of a quorum overwhelmingly voted in favor of management's other proposals, but voted against the dilutive option proposal.ⁿ⁵¹ The meeting was then adjourned for thirty days, with the polls left open on only the dilutive option proposal. During the adjournment, the company selectively contacted stockholders to solicit votes on the proposal. At the reconvened meeting, over 95 percent of the votes favored the proposal, which narrowly passed.ⁿ⁵²

The company and its Chairman moved for summary judgment, arguing that his decision to adjourn the meeting was protected by the business judgment rule. The court denied the defendants' motion, finding that the "primary purpose behind the adjournment was to ensure the passage" of the proposal.ⁿ⁵³ Sworn affidavits from company officers suggested that the adjournment was intended to achieve a favorable vote. Moreover, the company's failure to inform all stockholders of the adjournment and their ability to vote on the proposal while instead soliciting votes in secret from only certain stockholders suggested an intent to manipulate the vote. The court declined to rule on whether the defendants' proffered justifications, that included a concern for a low voter turnout on the proposal and apparent difficulties of European investors in voting, were sufficiently compelling to justify their otherwise inequitable conduct.ⁿ⁵⁴

[c] Record Date for Meetings

The continuous transfer of corporate shares necessitates that there be some specific time fixing the stockholders entitled to vote and receive notice of a meeting. At common law, corporations were permitted to close the corporation's share transfer books, thereby ceasing all the trading in their shares, for a reasonable period before a stockholders' meeting.ⁿ⁵⁵ Modern record date statutes enable the continuous trading of corporate shares by permitting a corporation to set a record date. The stockholders of record as of the record date, regardless of any subsequent transfers, are entitled to vote and receive notice of an upcoming annual meeting.ⁿ⁵⁶

Statutes permit the record date to be set within a certain time period preceding a stockholders' meeting. Statutes may permit the exact record date to be set by the corporation's bylaws or reserve power to the board to fix an exact date.ⁿ⁵⁷ Under Delaware's statute, the board of directors must fix a record date that is no more than 60 and no fewer than 10 days before the date of the meeting of stockholders.ⁿ⁵⁸ The board cannot set the record date retroactively by choosing a date that precedes the date on which their decision is made.ⁿ⁵⁹ If the board does not exercise its discretion to set a record date, the default record date is the day before notice is sent out to stockholders.ⁿ⁶⁰ If the meeting is adjourned, the statute authorizes directors to set a new record date for the reconvened meeting.ⁿ⁶¹

A board may abuse its discretion when it sets a record date in order to impede stockholder voting rights.ⁿ⁶² It is uncertain, however, what facts would suffice to cause the invalidation of a record date that otherwise complied with the statute. In *Wyser-Pratte v. Smith*,ⁿ⁶³ for example, the Court of Chancery dismissed a claim that the board had inequitably set the record date for only twelve days prior to a special meeting of stockholders. The plaintiffs argued that this short time period in which to act would discourage or impede stockholders from taking the necessary steps to exercise their voting rights.ⁿ⁶⁴ Having such a short time period in which to solicit proxies could also impair the stockholders' ability to wage a proxy fight. The court dismissed the plaintiff's claim, however, noting "[t]he impact of the selection of the record date on the logistics of the proxy contest were certainly known to the General Assembly when § 213 was enacted."ⁿ⁶⁵ Because the statute permits record dates that make proxy contests difficult and because plaintiff pled no specific facts regarding the board's alleged inequitable purpose, the court dismissed the plaintiff's claim.ⁿ⁶⁶

Similarly, in *In re The MONY Group, Inc., S'holders' Litig.*,ⁿ⁶⁷ the Court of Chancery upheld a board's decision to re-set the record date to determine stockholders entitled to vote on a merger that the board believed to be in the best interest of the corporation, holding the decision was committed to the directors' business judgment. There, the board re-set the record date for the related purposes of (1) enfranchising the approximately 52 percent of stockholders who purchased their shares during high volume trading after the original record date, and (2) enabling the merger to receive the statutorily required minimum approval of over half of all outstanding shares entitled to vote on the merger.ⁿ⁶⁸ Because neither of these purposes were tainted by director self-interestⁿ⁶⁹ and the action taken did not impede the exercise of the stockholder franchise, the court upheld the directors' decision under the deferential business judgment rule.

A new subsection to § 213, effective August 1, 2009, allows a board of directors to set one record date for determining shareholders entitled to receive notice of a meeting, and a second record date to establish the shareholders entitled to vote.^{n69.1} The voting record date can be later than the notice record date, including the date of the meeting. The requirement that the notice record date be not more than 60 and not less than 10 days before the meeting remains in effect. This change was meant to minimize "empty voting" by those who no longer own stock as of the meeting date or otherwise acquire voting rights without a corresponding economic interest and might therefore not vote in the manner most beneficial to the corporation.

[2] Electronic Meetings

A corporation's bylaws often do not provide a specific time and place for an annual meeting of stockholders, but, rather, specify the method by which the time and place may be determined. Statutes in Delaware and several other states permit stockholders' meetings to be held without any physical location whatsoever, solely by means of remote communication.ⁿ⁷⁰ Under Delaware law, stockholders will be deemed present at the meeting for quorum purposes, and entitled to vote, provided that the corporation implements reasonable measures (1) to verify stockholder or proxyholder status, (2) to enable participation in the meeting, including an opportunity to read or hear the proceedings substantially concurrently, and (3) maintain a record of any votes submitted by remote means.ⁿ⁷¹ Provided that the above requirements are met, a board that may otherwise determine the location of stockholder meetings may decide to dispense with a physical location altogether.ⁿ⁷²

Creating access via remote or electronic media may increase stockholder participation in the actual conduct of the meeting by eliminating the stockholders' need to travel to a physical location. Relatedly, dispensing with a physical location altogether may reduce the costs of the meeting to the corporation.ⁿ⁷³ The increased stockholder participation and flexibility afforded by electronic meetings, however, may constitute significant drawbacks from management's perspective; increased stockholder participation increases the risk that a large number of stockholders may revoke their votes at the meeting, thereby increasing the uncertainty associated with stockholder votes.ⁿ⁷⁴ From the stockholders' perspective, dispensing with any physical location may also impede the increased accountability thought to result from stockholders' direct interaction with management. Arguing that the benefits of increased stockholder participation through electronic means could always be achieved without dispensing with the physical location, stockholder activists have resisted corporate attempts to eliminate physical meeting sites.ⁿ⁷⁵

[3] Vote Required for Transaction of Business

[a] General Rule

In Delaware, absent a contrary bylaw or charter provision or a specific statutory requirement (such as in the case of stockholder approval of mergers):ⁿ⁷⁶

- (1) a majority of the shares entitled to vote, which when present in person or represented by proxy at the meeting, shall constitute a quorum;
- (2) in all matters on which shareholders are entitled to vote, other than the election of directors, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter of the particular proposal concerned shall be necessary and sufficient for the conduct of business; and
- (3) directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors; and
- (4) the same rules apply when a separate vote of a class or series of shares is required, except that the shares counted for purposes of determining the required quorum or vote are limited to those in that class or series.

These rules can be changed by charter or bylaw provisions except that in no event shall a quorum be less than one-third of the shares entitled to vote at the meeting (or, in the case of a vote required of a class or series of shares, one-third of the shares in that class or series).ⁿ⁷⁷ Once a quorum is established by the presence in person or representation by proxy of the requisite number of shares, a shareholder or proxy-holder cannot subsequently defeat the quorum by physically withdrawing from the meeting.ⁿ⁷⁸

[b] Abstentions and Broker Non-Votes

There is of course no duty to exercise voting rights associated with stock ownership.ⁿ⁷⁹ Stockholders abstain from voting when they are present at a meeting and are otherwise entitled to vote, but decline to cast a vote on a particular matter.ⁿ⁸⁰ States are split over how (and whether) to count abstentions for voting purposes.ⁿ⁸¹ States with statutes like Delaware's, which generally require an affirmative vote of the majority of shares present or represented and entitled to vote in order for a proposal to pass, have the effect of counting abstentions as negative votes.ⁿ⁸² In contrast, the Model Business Corporation Act and approximately half of the states generally only require that the votes cast for a proposal exceed the votes cast against the proposal.ⁿ⁸³

Similar to abstentions, beneficial owners of stock may inadvertently prevent their shares from being voted on a

particular proposal by failing to give the record owners (*i.e.*, agents of the beneficial owners, such as stock brokers, who are said to hold shares in "street name") either voting discretion or specific instructions with regards to a particular proposal.ⁿ⁸⁴ State law authorizes such fiduciaries to vote the stock they hold on behalf of beneficial owners,ⁿ⁸⁵ and authorizes corporations to rely on and communicate solely with record owners when communicating regarding upcoming votes.ⁿ⁸⁶ With respect to voting in publicly held companies, the specific nature of the fiduciary relationship between record and beneficial owners is governed by stock exchange rules. For example, New York Stock Exchange Rule 452 governs when NYSE member brokers holding shares in "street name" may vote those shares without specific voting instructions of the beneficial holders.ⁿ⁸⁷ Generally, to be able to do so, a NYSE member organization must have transmitted the proxy statement and accompanying materials to the beneficial holder or his or her designated investment advisor, not have received voting instructions from the beneficial holder or designated investment advisor, and have "no knowledge of any contest as to the action to be taken at the meeting and provided such action is adequately disclosed to stockholders and does not include authorization for a merger, consolidation of any matter which may affect substantially the rights or privileges of such stock." Procedurally, once the Exchange has reviewed the proxy statement, it designates in the list of stockholder meetings appearing in the Weekly Bulletin whether (a) members may vote a proxy without instructions of beneficial owners, (b) members may not vote on specific matters on the proxy, or (c) members may not vote the proxy at all.ⁿ⁸⁸

The Delaware Supreme Court distinguished between abstentions and broker non-votes in *Berlin v. Emerald Partners*.ⁿ⁸⁹ In that case, the court recognized that, unlike abstentions, broker non-votes with respect to a particular proposal occur precisely because the record owners are not "entitled to vote" with respect to the particular matter.ⁿ⁹⁰ For this reason, unlike abstentions, broker non-votes should not be counted towards a quorum with respect to the particular proposals for which they cannot vote.ⁿ⁹¹ For similar reasons, unlike abstentions, broker non-votes will not be treated as votes against a particular proposal.

[4] Stockholder Proposals

[a] State Law

Delaware law does not expressly address substantive requirements for proposals submitted by stockholders for consideration at an upcoming meeting. Nevertheless, many corporations have procedural requirements that must be complied with before a proposal may be considered at an annual meeting. These frequently take the form of advance notice provisions in the company charter or bylaws, which require that stockholders provide a company with notice of certain proposals a set period in advance of a meeting.ⁿ⁹² While courts regard advance notice provisions as defensive measures,ⁿ⁹³ they are generally held to be a valid means of ensuring that a corporation has sufficient time to include any proposal in its proxy materials and to allow a period of deliberation prior to the meeting.ⁿ⁹⁴

A close reading of the bylaw is necessary to determine how an advance notice provision will operate. For example, in *Jana Master Fund, Ltd. v. CNET Networks, Inc.*,^{n94.1} the bylaws required a stockholder to have beneficially owned at least \$1,000 in common stock for a year before seeking to transact business at the annual meeting. Although the shareholder had held shares for only eight months, the court of chancery held that the corporation could not exclude the shareholder's proposals, because the bylaw only applied to shareholder proposals under SEC Rule 14a-8. Similarly, ^{n94.2} the chancery court narrowly interpreted an advance notice bylaw in favor of the shareholder. Although the court concluded that the bylaw in question did cover nomination of directors, the court held that the shareholder's nomination of alternate directors was proper business for the annual meeting because the directors' own notice of meeting announced that one matter to be addressed was election of the board of directors.

Even when interpreted to operate as intended, advanced notice provisions may be problematic where they unreasonably impair the exercise of the stockholder franchise--particularly the ability of stockholders to nominate directors.ⁿ⁹⁵ In *Lerman v. Diagnostic Data, Inc.*, for example, the court invalidated an incumbent board's use of a 70 day advance notice bylaw to prevent a known insurgent from nominating his slate of directors, where the board gave stockholders

only 63 days' notice of the annual meeting date.ⁿ⁹⁶ Similarly, in *Linton v. Everett*, the court set aside a stockholder vote re-electing the incumbent board where the board gave short notice of an annual meeting in deviation from its prior practice, inevitably in a manner foreseeably adverse to any shareholder desiring to nominate an opposing slate.ⁿ⁹⁷ Advance notice provisions may also have an inequitable effect where "a material change of circumstances" occurs after the submission deadline of an advance notice provision.ⁿ⁹⁸ In *Hubbard v. Hollywood Park Realty Enters., Inc.*, such a material change was present, requiring the board to waive the application of an advance notice provision, where the board entered into a settlement agreement with an insurgent stockholder three weeks after the submission deadline, which required the board to nominate the insurgent for a directorship.ⁿ⁹⁹ The "unanticipated change of allegiance by a majority" of the board in aligning itself with the insurgent, who had previously indicated an intent to make fundamental changes to the company's management, operations, and business policy, mandated waiver of the advance notice requirement.ⁿ¹⁰⁰ Finally, the Court of Chancery has invalidated the board's interpretations of advance notice provisions, when they were announced at a time so as to have the effect of impeding a takeover attempt and perpetuating current management.ⁿ¹⁰¹

[b] Proxy Rules

[i] Amended Rule 14a-8 n102

SEC Rule 14a-8, adopted under the 1934 Act, addresses when a company must include a stockholder's proposal in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of stockholders. As amended in 1998, the Rule includes detailed requirements, procedures, and standards for analyzing stockholder proposals. In summary, to require a company to include a proposal on the company's proxy card, and to include the proposal and any supporting statement in its proxy statement, the stockholder must be eligible and follow certain procedures. Under certain circumstances, the company is permitted to exclude the proposal, but only after submitting its reasons to the SEC.

[ii] Procedural Issues

A stockholder who holds at least \$2,000 in market value, or one percent, of a corporation's stock entitled to vote on a proposal and who has held that stock continuously for at least one year prior to its submission (and continues to hold the stock through the date of the meeting) may submit one proposal to a corporation for inclusion on the company's proxy statement and on the company's proxy card for a shareholder vote at an upcoming stockholders meeting. The proposal, including the accompanying supporting statement, may not exceed 500 words.

Stockholders under common control and family members are limited to one proposal for the group.ⁿ¹⁰³ If a proposal is several proposals combined into one, the proposal need not be included in the corporation's proxy material.ⁿ¹⁰⁴ If the proponent violates the one-proposal rule, the corporation must ask the proponent to reduce the number of proposals to one. If the corporation fails to make such a request, the additional proposals may not be omitted from the proxy materials.ⁿ¹⁰⁵ If the corporation makes such a request and the proponent fails to comply, the corporation may omit the proposals from the proxy materials.ⁿ¹⁰⁶

Before a corporation may exclude a proposal from its proxy material, the corporation must notify the stockholder of the problem with the proposal within 14 days of receipt and allow the stockholder to correct the problem. The stockholder must respond to the corporation's notice within 14 days of receiving the corporation's notice. If the deficiency in the stockholder proposal cannot be remedied (*e.g.*, the stockholder has not held the required number of shares for one year prior to the submission of the proposal), the corporation is not required to notify the stockholder of the deficiency prior to omitting the proposal. The burden is on the corporation to show that a proposal can be excluded.

A stockholder, or a representative appearing on the stockholder's behalf, must attend the stockholder meeting to present the proposal. If a stockholder, or the stockholder's representative, fails to attend the stockholder's meeting to present the

proposal, the corporation is entitled to exclude all of such stockholder's proposals from the corporation's proxy materials for any meetings held within the following two years.

If a corporation intends to exclude a stockholder proposal, the corporation must file its reasons for excluding the proposal, including applicable SEC authority or supporting law, with the SEC at least 80 days before it files its definitive proxy statement and must send a copy of its SEC submission to the proponent. The proponent is entitled, but not required, to file a response to the corporation's submission with the SEC.

[iii] *Grounds for Exclusion of Stockholder Proposals*

The 13 subparagraphs of Question 9 set forth the substantive grounds for excluding a stockholder proposal from the corporation's proxy statement.

Under Rule 14a-8(i)(1), a corporation may exclude a stockholder proposal if the proposal is not a proper subject for stockholder action under the law of the company's domicile. Because the laws of most states include language similar to Delaware's requirement that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors,"ⁿ¹⁰⁷ the SEC staff has determined that proposals mandating the board to take certain action "may constitute an unlawful intrusion on the board's discretionary authority under the typical statute."ⁿ¹⁰⁸ Therefore, the SEC has allowed companies to exclude from their proxy materials mandatory stockholder proposals on issues that state law normally relegates to the authority and discretion of the board of directors.ⁿ¹⁰⁹

Nevertheless, the SEC has also stated that "proposals that merely recommend or request that the board take certain action would not appear to be contrary to the typical state statute."ⁿ¹¹⁰ For this reason, shareholder proposals, especially those dealing with fundamental matters of corporate governance (such as, for example, the repeal of bylaw provisions classifying corporate boards so that only one-third of the directors are elected each year, or the redemption of shareholder-rights plans), are often precatory, rather than mandatory.

The combined effect of the federal proxy rules and state law in this regard has raised an issue for corporate governance activists about how boards of directors should react to the adoption of precatory shareholder proposals, especially those that are adopted by an overwhelming majority vote of the shareholders.ⁿ¹¹¹ For purposes of this treatise, suffice it to say that some shareholder activists would like companies to treat precatory resolutions receiving the affirmative vote of a clear majority of shares outstanding voted as, in essence, mandatory, despite the SEC's historical position under proxy rule 14a-8(i)(1).ⁿ¹¹²

To get around the "proper subject for action by shareholders" restriction of Rule 14a-8(i)(1), some shareholder proponents have taken to casting their proposals as actions to amend corporate bylaws. In Delaware, as in most other states, corporate bylaws may be amended directly by the shareholders.ⁿ¹¹³ Commentators have questioned the validity of using mandatory bylaw proposals to end-run the "proper subject for action by shareholders" restriction and the basic principle that the business of every corporation is managed by or under the direction of the board of directors.ⁿ¹¹⁴ Nevertheless, one federal court has upheld the validity, under Oklahoma law, of a shareholder proposal for a mandatory bylaw amendment requiring a company to redeem its shareholder rights plan.ⁿ¹¹⁵

Under Rule 14a-8(i)(2), a corporation may omit a stockholder proposal if the proposal could require the corporation to violate state, federal or foreign law.ⁿ¹¹⁶ In 2008, the SEC, for the first time, requested the opinion of the Delaware Supreme Court on the validity of a proposed shareholder bylaw mandating reimbursement of dissidents' solicitation expenses in a successful short slate proxy fight.^{n116.1} Partially resolving a longstanding debate about the relationship between Delaware Code Sections 109(b) and 141(a), the Supreme Court concluded that such a mandatory bylaw was a "proper subject for action by the shareholders," and did not unduly encroach upon the board's authority simply by requiring the payment of money, but the particular proposal was illegal under Delaware law because could result in

mandating that the board pay money in a manner that violated its fiduciary duties, for example, "in a situation where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation."

Under Rule 14a-8(i)(3), a corporation may exclude a stockholder proposal if the proposal is contrary to any of the SEC's proxy rules. Typically, this rule is applied to exclude proposals that are vague or misleading or to require revisions to proposals that contain vague or misleading statements.ⁿ¹¹⁷

Under Rule 14a-8(i)(4), a corporation may exclude stockholder proposals addressing personal claims or grievances or to further the personal interest of a stockholder.ⁿ¹¹⁸

Rule 14a-8(i)(5) allows a corporation to exclude stockholder proposals that are not significantly related to the corporation's business. The provision permits omission of a stockholder proposal that is related to operations that account for less than five percent of the corporation's total assets and less than five percent of the corporation's net earnings and gross sales, and "is not otherwise significantly related to the issuer's business." According to the SEC, this provision "relates to proposals concerning the functioning of the economic business of an issuer and not to such matter as stockholders' rights, *e.g.*, cumulative voting."ⁿ¹¹⁹ The SEC has cited the above-quoted language relating to the "functioning of the economic business" to conclude that certain proposals meeting the economic insignificance test are nevertheless not excludable if they urge particular social or political positions.ⁿ¹²⁰

Rule 14a-8(i)(6) allows a corporation to exclude stockholder proposals that are beyond the corporation's power to effectuate. Under this rule, the staff SEC has issued "no-action" letters relating to proposals that would require the corporation to violate existing legal obligations.ⁿ¹²¹ The staff has also allowed exclusion of proposals that set vague or general objectives and do not suggest specific means for achieving such objectives.ⁿ¹²² Under this provision, the staff has also issued "no-action" letters regarding proposals that have attempted to regulate stockholder decisions and that are beyond the power of the corporation to implement.ⁿ¹²³

Rule 14a-8(i)(7) allows a corporation to exclude proposals dealing with the ordinary business operations of the corporation.ⁿ¹²⁴ Even in matters involving fundamental corporate governance procedures, the SEC has allowed the exclusion of shareholder proposals on the ground that "they relate to the ordinary business operations of the corporation."ⁿ¹²⁵

In 2002, the SEC changed its position significantly on the issue of whether certain executive-compensation-related proposals could be excluded on "ordinary business" grounds.ⁿ¹²⁶ The SEC declared that the "ordinary business" exclusion would not be available to exclude proposals focusing on equity compensation plans used to compensate only senior executive officers and directors. A few months later, the SEC underscored the point by reversing the Corporation Finance staff's position in a case involving National Semiconductor. The SEC concluded that the company could not exclude, under the "ordinary business" exclusion, a proposal that would require expensing of stock options.ⁿ¹²⁷

Rule 14a-8(i)(8) allows a corporation to exclude proposals dealing with elections to office.ⁿ¹²⁸

Rule 14a-8(i)(9) allows a corporation to exclude a proposal that directly conflicts with the corporation's own proposal.ⁿ¹²⁹

Rule 14a-8(i)(10) allows a corporation to omit a proposal if the proposal has been rendered moot because the corporation has already substantially implemented the proposal.ⁿ¹³⁰

Rule 14a-8(i)(11) allows a corporation to omit a proposal that is substantially duplicative of a proposal submitted by another stockholder that will be included in the corporation's proxy material.ⁿ¹³¹

Rule 14a-8(i)(12) allows a corporation to omit resubmissions or proposals that address substantially the same subject matter as proposals included in the corporation's proxy materials during the preceding five years if the proposal did not receive a required percentage of votes.ⁿ¹³²

Rule 14a-8(i)(13) allows a corporation to omit stockholder proposals dealing with specific amounts of cash or stock dividends.ⁿ¹³³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Shareholders Meetings & Voting Annual Meetings Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Proxies General Overview

FOOTNOTES:

(n1)Footnote 1. *Del. Code Ann. tit. 8, § 211(b)*.

(n2)Footnote 2. *See Del. Code Ann. tit. 8, § 211(b)*.

(n3)Footnote 3. *See Del. Code Ann. tit. 8, § 211(b)*.

(n4)Footnote 4. *See Hoschett v. TSI Int'l. Software, Ltd., 683 A.2d 43, 46-47 (Del. Ch. 1996)*.

(n5)Footnote 5. *See Del. Code Ann. tit. 8, § 211(b)*.

(n6)Footnote 6. *See Drexler et. al, Delaware Corporation Law and Practice, § 24.02 (LexisNexis Matthew Bender)*.

(n7)Footnote 7. *See generally Drexler et al., Delaware Corporation Law and Practice, §§ 24.01-24.06 (discussion of stockholder meetings) and Balotti et al., Meetings of Stockholders § 2.1 at 2-4 (2003 Supp.)*.

(n8)Footnote 8. *See, e.g., Byrne v. Lord, CAs 14040, 14215, 1995 Del. Ch. LEXIS 131, **25-26 (Nov. 9, 1995); Walsh v. Search Exploration, Inc., CA 11673, 1990 Del. Ch. LEXIS 132, *9 (Aug. 31, 1990); Tweedy, Browne and Knapp v. The Cambridge Fund, Inc., 318 A.2d 635, 636 (Del. Ch. 1974)*.

(n9)Footnote 9. *See Del. Code Ann. tit. 8, § 211(a) and (b)*.

(n10)Footnote 10. *See Del. Code Ann. tit. 8, § 211(a)*.

(n11)Footnote 11. *See Del. Code Ann. tit. 8, § 211(a)*.

(n12)Footnote 12. *See Del. Code Ann. tit. 8, § 211(a)(2)*.

(n13)Footnote 13. *See Del. Code Ann. tit. 8, § 211(c)*.

(n14)Footnote 14. *See Del. Code Ann. tit. 8, § 211(c); see also NiSource Capital Markets, Inc. v. Columbia Energy Group., CA 17251; letter op. at 4-5, Chandler, C. (Del. Ch. 1999)*.

(n15)Footnote 15. *Del. Code Ann. tit. 8, § 211(c); see, e.g., Byrne, 1995 Del. Ch. LEXIS 131, **23-24*. The fact that a corporation has announced it will hold an annual meeting on some future date is irrelevant to, and does not render moot, a complaint alleging that an annual meeting has not been held within the statutory period. *See MFC Bancorp. Ltd. v. Equidyne Corp., CA 20386, 844 A.2d 1015, 2003 Del. Ch. LEXIS 86, **15-16 (Aug. 13, 2003)*.

(n16)Footnote 16. *See Del. Code Ann. tit. 8, § 211(c)*.

(n17)Footnote 17. *See Del. Code Ann. tit. 8, § 211(c); see also MFC Bancorp. Ltd., 844 A.2d 1015, 2003 Del. Ch. LEXIS 86, **13-14.*

(n18)Footnote 18. *See, e.g., Meredith v. Sec. Am. Corp., CA 6606, 1981 Del. Ch. LEXIS 633 (Nov. 18, 1981)* (ordering annual meeting to be held despite that reinsurance company was no longer authorized to do business in any jurisdiction, and operations consisted solely of management of various lawsuits, including forced liquidation proceeding).

(n19)Footnote 19. *Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 669 (Del. Ch. 1988); see also Sutton Holding Corp. v. DeSoto, Inc., CA 12051, 1991 Del. Ch. LEXIS 85, *3 (May 14, 1991)* .

(n20)Footnote 20. *See MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1131 (Del. 2003); Stroud v. Grace, 606 A.2d 75, 90-92 (Del. 1992)* .

(n21)Footnote 21. *See, e.g., Dolgoff v. Projectavision, Inc., CA 14805, 1996 Del. Ch. LEXIS 24 (Feb. 29, 1996)* . The presence of an inequitable purpose does not depend upon any showing of subjective bad faith or selfish motive. *See Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1121-22 (Del. Ch. 1990)* .

(n22)Footnote 22. *Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971)* .

(n23)Footnote 23. *See Schnell., 285 A.2d at 438-39* .

(n24)Footnote 24. *See Schnell, 285 A.2d at 438-39* .

(n25)Footnote 25. *Schnell, 285 A.2d at 438-39* .

(n26)Footnote 26. *See Schnell, 285 A.2d at 440* .

(n27)Footnote 27. *See Gintel v. XTRA Corp., C.A. No. 11422, mem. op. at 7-8, Allen, C. (Del. Ch. Feb. 27, 1990); Aprahamian v. HBO & Co., 531 A.2d 1204 (Del. Ch. 1987)* .

(n28)Footnote 28. *Aprahamian, 531 A.2d 1204* .

(n29)Footnote 29. *See Aprahamian, 531 A.2d at 1205* .

(n30)Footnote 30. *See Aprahamian, 531 A.2d 1204* .

(n31)Footnote 31. *See Aprahamian, 531 A.2d at 1207* .

(n32)Footnote 32. The court ignored the defendants' argument that they needed more time to carry out a recent decision to explore a possible sale of the company. *Aprahamian, 531 A.2d at 1207* . The dissident stockholders' proposed slate of directors also ran on a platform of exploring a possible sale.

(n33)Footnote 33. *See Aprahamian, 531 A.2d at 1209* . Directors' bewildering maneuvers may, in some rare circumstances, require the postponement of an annual meeting to ensure the legitimacy of a stockholder vote. *See, e.g., Am. Pac. Corp. v. Super Food Services, Inc., CA 7020, 1982 Del. Ch. LEXIS 551, *11 (Dec. 6, 1982)* (holding that a stay of an annual meeting was necessary to ensure stockholders' right to a fair proxy contest, in light of directors' recommendation of possible illegal charter amendments and dissemination of confusing supplemental disclosures).

(n34)Footnote 33.1. *Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d 786 (Del. Ch. 2007)* .

(n35)Footnote 33.2. *Mercier, 929 A.2d at 810-11* ("To ultimately succeed, the directors must show that their

actions were reasonable in relation to their legitimate objective, and did not preclude the stockholders from exercising their right to vote or coerce them into voting a particular way."); *See also Portnoy v. Cryo-Cell Intern., Inc.*, 940 A.2d 43 (Del. Ch. 2008) .

(n36)Footnote 34. *See, e.g., H.F. Ahmanson & Co. v. Great W. Fin. Corp.*, CAs 15650, 15549, 15555-15557 and 15577, 1997 Del. Ch. LEXIS 84, *55 (June 3, 1997) (upholding postponement, reasoning that the seven week delay "will not frustrate the effective exercise of the ... shareholders' franchise"); *Huffington v. Enstar Corp.*, CA 7543, 1984 Del. Ch. LEXIS 492, *7 (Apr. 25, 1984) (upholding 28-day delay where plaintiff showed no harm; reasoning that stockholders "are not being denied the opportunity to vote or to participate in the annual meeting. They are given more time to prepare for it"); *accord Hubbard v. Hollywood Park Realty Enter. Inc.*, CA 11779, 1991 Del. Ch. LEXIS 9, *34 (Jan. 14, 1991) ; *Cf. Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 913-14 (Del. Ch. 1980) .

(n37)Footnote 35. *See, e.g., Stahl v. Apple Bancorp*, 579 A.2d 1115, 1123 (Del. Ch. 1990) (explaining that "the action of deferring [an] annual meeting where no meeting date has yet been set and no proxies [have] even [been] solicited does not impair or impede the effective exercise of the franchise to any extent"); *see also Dolgoff v. Projectavision, Inc.*, CA 14805, 1996 Del. Ch. LEXIS 24 (Feb. 29, 1996) (following the Stahl decision in upholding directors' decision to hold annual meeting nine months earlier than usual in order to surprise dissident director with boards' recommendation that he not be re-elected).

(n38)Footnote 36. *See, e.g., Huffington*, 1984 Del. Ch. LEXIS 492 at *9 (refusing to presume that incumbent board "will breach its fiduciary duties and conclude a sale that is not in the best interests of the stockholders").

(n39)Footnote 37. *See, e.g., H.F. Ahmanson*, 1997 Del. Ch. LEXIS 84 at **6-8, 54-58 (upholding delay where board needed time to investigate strategic alternatives to unsolicited offer); *Stahl*, 579 A.2d 1115 (same); *see also MAI Basic Four, Inc., v. Prime Computer, Inc.*, CA 10868, 1989 Del. Ch. LEXIS 69, *3 (June 13, 1989) (upholding delay where plaintiff made coercive tender offer less than two weeks before scheduled meeting).

(n40)Footnote 38. *See generally* Balotti et. al, Meetings of Stockholders § 8.11 (2004 Supp.); *see also State of Wis. Investment Bd. v Peerless Sys., Corp.*, CA 17637, 2001 Del. Ch. LEXIS 1, *6 (Jan. 5, 2001) (listing circumstances justifying adjournment); *Mentor Graphics Corp. v. Quickturn Design Sys.*, 789 A.2d 1216, 1219 (Del. Ch. 2001) (acquirer adjourned special meeting where court had not decided validity of target's defensive measures).

(n41)Footnote 39. *See generally* Fletcher's Cyclopedia of Corporations § 2014 (2002 Supp.).

(n42)Footnote 40. *See, e.g., Model Bus. Corp. Act* § 7.08 (2002 Supp.) (permitting bylaws or board to appoint a chair to preside over and direct meeting).

(n43)Footnote 41. *See Del. Code Ann., tit. 8, § 222(c)*.

(n44)Footnote 42. *See Del. Code Ann., tit. 8, § 222(c); accord Model Bus. Corp. Act* § 7.05(e) (2002 Supp.).

(n45)Footnote 43. *See Mesa Petroleum Co. v. Unocal Corp.*, CA 7997, 1985 Del. Ch. LEXIS 461 (Apr. 22 1985) ; *Atterbury v. Consol. Coppermines Corp.*, 26 Del. Ch. 1, 20 A.2d 743 (Del. Ch. 1941) ; *accord In re Election of Dir. of Bushwick Sav. & Loan Ass'n.*, 189 Misc. 316, 70 N.Y.S. 2d 478, 481 (N.Y. Sup. 1947) .

(n46)Footnote 44. *Atterbury*, 26 Del. Ch. 1, 20 A.2d 743 .

(n47)Footnote 45. *Del. Code Ann., tit. 8, § 222(c)*.

(n48)Footnote 46. *See Berlin v. Emerald Partners*, 552 A.2d 482, 493 (Del. 1989) ; *Duffy v. Loft, Inc.*, 17 Del. Ch. 376, 152 A. 849 (Del. 1930) ; *Hexter v. Columbia Baking Co.*, 16 Del. Ch. 263, 145 A. 115 (Del. Ch. 1929) .

(n49)Footnote 47. *See* § 3.05[1][a] above.

(n50)Footnote 48. *State of Wisconsin Inv. Board v. Peerless Sys. Corp.*, CA 17637, 2000 Del. Ch. LEXIS 170 (Dec. 4, 2000) .

(n51)Footnote 49. *State of Wisconsin Inv. Bd.*, **1-2. Section 231(c) of the Delaware General Corporation Law provides that "[t]he date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote ... shall be announced at the meeting." *See Del. Code Ann., tit. 8, § 231(c)*. It further states that no votes may be added or changed after the closing of the polls, unless a stockholder convinces the Court of Chancery otherwise. *See Del. Code Ann., tit. 8, § 231(c)*. While this statute would seem relevant to the validity of the conduct at issue in *Peerless*, no Delaware court has applied it in this context.

(n52)Footnote 50. *State of Wisconsin Inv. Bd.*, at **6-7.

(n53)Footnote 51. *State of Wisconsin Inv. Bd.*, at **8-11.

(n54)Footnote 52. *See State of Wisconsin Inv. Bd.*, at **16-17; *Cf. Derdiger v. Tallman*, (Sept. 11, 2002), 773 A.2d 1005 (holding business judgment rule would apply to one-day adjournment while keeping the polls open on re-domestication merger vote, where plaintiff alleged only that the proposal barely passed, without pleading facts suggesting any interference with or manipulation of the stockholder franchise).

(n55)Footnote 53. *State of Wis. Inv. Board*, 2000 Del. Ch. LEXIS 170 at *39 .

(n56)Footnote 54. *See State of Wisconsin Inv. Bd.*, , at **47, 50. Shortly after the *Peerless* decision, defendants in a suit with almost identical facts settled the plaintiff's voting manipulation claims. The court awarded the plaintiffs' attorneys' fees in recognition that the cessation of probable voting manipulation constitutes a benefit to the corporation and its stockholders. *See La. State Employees' Ret. Sys. v. Citrix Sys., Inc.*, CA 18298, 2001 Del. Ch. LEXIS 115 (Sept. 17, 2001) . One year later, in *Coates v. Netro Corp.*, No. 19154, 2002 WL 31112340, *2 (Del. Ch. Sept. 11, 2002), the Chancery court looked more kindly on a much shorter delay, observing that the mere fact that a meeting adjourned on May 31 and reconvened on June 1 did not state a cognizable claim for voting manipulation because "the plaintiff does not show 'that the primary purpose of the board's action was to interfere with or impede exercise of the shareholder franchise'" and that the adjournment therefore "receives the benefit of the business judgment rule."

(n57)Footnote 55. *See generally* Model Bus. Corp. Act Annot. § 7.07 at 7-67 to 68 (3d ed. 2002) (describing the historical background of modern record date statutes).

(n58)Footnote 56. Post record date transfers may, as a practical matter, have the effect of eliminating the voting rights associated with the transferred shares. *See In re The MONY Group, Inc. S'holders' Litig.*, CA 20554, 853 A.2d 661, 2004 Del. Ch. LEXIS 35 , **10-11 (Apr. 9, 2004) (recognizing that shares often do not trade with a proxy permitting the purchaser to vote and that many large institutional investors will not exercise the voting rights associated with shares they have since traded).

(n59)Footnote 57. *See generally* Fletcher's Cyclopedia of Corporations § 2007 at 52-53 (1996); *see also* Revised Model Bus. Corp. Act § 7.07 (2002 Supp.) (permitting bylaws or, absent a bylaw, board of directors to specify record date).

(n60)Footnote 58. *Del. Code Ann. tit. 8, § 213(a)*.

(n61)Footnote 59. *See Del. Code Ann. tit. 8, § 213(a)*.

(n62)Footnote 60. *Del. Code Ann. tit. 8, § 213(a)*.

(n63)Footnote 61. *Del. Code Ann. tit. 8, § 213(a); Del. Code Ann. tit. 8, § 222(c)*.

(n64)Footnote 62. *See Wyser-Pratte*, (Mar. 18, 1997) (stating that a voting manipulation claim could be stated in

the context of setting a record date); *cf.* *Gintel v. XTRA Corp.*, CA 11422 (Del. Ch. Feb. 27, 1990) (permitting brief adjournment where the same record date was preserved).

(n65)Footnote 63. *Wyser-Pratte, 1997 Del. Ch. LEXIS 41, at *41* .

(n66)Footnote 64. *See Wyser-Pratte, 1997 Del. Ch. LEXIS 41, at *41* .

(n67)Footnote 65. *See Wyser-Pratte, 1997 Del. Ch. LEXIS 41, at *6* .

(n68)Footnote 66. *See Wyser-Pratte, 1997 Del. Ch. LEXIS 41, *6* ; *see also Golden Cycle LLC v. Allan, CA 16301, 1998 Del. Ch. LEXIS 80, *23 (May 20, 1998)* (refusing to apply heightened scrutiny to record date set in compliance with statute, even though "the haste with which the Board acted to fix the record date and the Company's failure to give prompt notice of its establishment to suggest that [the Board] thought their actions would limit or interfere with [the plaintiff-stockholder's] ability to solicit consents"); *accord McDonough v. Foundation Co.*, 7 Misc. 2d 571, 155 N.Y.S.2d 67 (N.Y. Sup. Ct. 1956) (reasoning that, because the record date procedure is "intended for the administrative convenience of corporations ... rather than for the benefit of stockholders" there was no valid reason to deny the board the power to change the record date for a meeting to be reconvened after adjournment).

(n69)Footnote 67. *In re The MONY Group, Inc., S'holders' Litig.*, CA 20554, 853 A.2d 661, 2004 Del. Ch. LEXIS 35 (April 12, 2004) .

(n70)Footnote 68. *The MONY Group, 2004 Del. Ch. LEXIS 35, at *21* .

(n71)Footnote 69. The court distinguished cases applying heightened scrutiny to board decisions impacting votes in contested elections of directors. *See The MONY Group, 853 A.2d 661, 2004 Del. Ch. LEXIS 35* , at **24-28.

(n72)Footnote 69.1. 2009 Del. Laws Ch. 14, § 5, effective Aug. 1, 2009.

(n73)Footnote 70. *See, e.g., Model Bus. Corp. Act § 7.01 comm. at 7-8 (2002 Supp.)* (listing Delaware, Oklahoma, and Michigan as states permitting meeting to be held solely by remote communication.); *see also Md. Code Ann., Corps. & Ass'ns, § 2-503*.

(n74)Footnote 71. *See Del. Code Ann. tit. 8, § 211(a)(2)*.

(n75)Footnote 72. *See Del. Code Ann. tit. 8, § 211(a)(1)*.

(n76)Footnote 73. One of the few companies to have meetings solely by means of remote communication, Inforte, Inc., reported spending only \$2,000 of the \$20,000 it normally budgeted for its annual meeting. Significant cost savings were tied to simpler planning and eliminating the need for management and the board to travel to the meeting. *See Broc Romanek, Use of Electronic Access to Physical Stockholders' Meetings, available at www.realcorporatelawyer.com/faqs/meetings.html* (last visited Mar. 31, 2004).

(n77)Footnote 74. *See generally* Jesse A. Finklestein, *Shareholder Meetings in Cyberspace: Will Your Next Meeting Location Be a Website?*, Insights, Vol. 14, No. 6 at 15 (June 2000); *see also* Gregory V. Varallo and Richard P. Rollo, *Developments in Shareholders' Meetings: New Delaware Legislation and the ABA Handbook*, Insights, Vol. 15, No. 1 at 11 (Jan. 2001) (explaining that, because of this increased uncertainty, "well advised corporate boards would not want to hold *contested* cyberspace meetings").

(n78)Footnote 75. *See, e.g.,* The Council of Institutional Investors, *Council Policies - Shareholder Meetings, available at www.cii.org* (last visited Mar. 31, 2004) (stating "Companies should hold shareholder meetings by remote communication (so-called electronic or 'cyber' meetings) only as a supplement to traditional in-person shareholder meetings, not as a substitute"); *see also Delaware Law Allows "Virtual" Annual Meetings, available at www.socialfunds.com/news/article.cgi/article296.html* (last visited Mar. 31, 2004) (noting that the amendment to

Delaware's General Corporation Law passed despite "vigorous attempts by shareholder advocacy groups" to impede it).

(n79)Footnote 76. *Del. Code Ann. tit. 8, § 216*.

(n80)Footnote 77. *Del. Code Ann. tit. 8, § 216*.

(n81)Footnote 78. *Duffy v. Loft, Inc., 17 Del. Ch. 376, 152 A. 849, 853 (Del. 1930)* .

(n82)Footnote 79. *See, e.g., Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441, 447 (Del. 1947)* (stating that "[t]he ownership of voting stock imposes no legal duty to vote at all"); *accord* SEC Rule 14a-4b(1) (requiring that proxy cards permit stockholders to vote for, against, or abstain from voting with respect to each matter presented for a stockholder vote).

(n83)Footnote 80. *See generally Hammersmith v. Elmhurst-Chicago Stone Co., CA 10,837, 1989 Del. Ch. LEXIS 98 (Aug. 17, 1989)* (citing lay dictionary).

(n84)Footnote 81. In contrast, voluntary abstentions of shares entitled to vote are counted for purposes of state statutes giving default quorum requirements. *See generally* Fletcher's Cyclopedia of Corporations § 2013 (1996 Supp.) (reporting that a majority of states, like Delaware, have default quorum provisions providing that a majority of shares entitled to vote constitute a quorum); *see also Duffy v. Loft, Inc., 17 Del. Ch. 140, 151 A. 223 (Del. Ch. 1930)* , *aff'd, 17 Del. Ch. 376, 152 A. 849 (Del. 1930)* .

(n85)Footnote 82. *See Del. Code Ann. tit. 8, § 216(2)*. Running against this general rule, directors may be elected by a plurality of the shares present or represented by proxy and entitled to vote. *See Del. Code Ann. tit. 8, § 216(2)* at § 216(3).

(n86)Footnote 83. *See* Model Bus. Corp. Act § 7.25(c), and comm. thereto (1999 Supp.); *see, e.g., N.Y. Bus. Corp. Law § 614(b)* ("Whenever any corporate action, other than the election of directors, is to be taken under this chapter by vote of the shareholders, it shall, except as otherwise required by this chapter or by the certificate of incorporation as permitted by this chapter or by the specific provisions of a bylaw adopted by the shareholders, be authorized by a majority of the votes cast in favor of or against such action at a meeting of shareholders by the holders of shares entitled to vote thereon. Except as otherwise provided in the certificate of incorporation or the specific provision of a bylaw adopted by the shareholders, an abstention shall not constitute a vote cast.").

(n87)Footnote 84. *See Berlin v. Emerald Partners, 552 A.2d 482, 494 (Del. 1989)* .

(n88)Footnote 85. *See Del. Code Ann. tit. 8, § 217(a)*.

(n89)Footnote 86. "[I]n dealing with its stockholders a Delaware corporation need not look beyond the registered owners." *Berlin v. Emerald Partners, 552 A.2d 482, 494 (Del. 1989)* , quoting, *Williams v. Sterling Oil of Oklahoma, Inc., 267 A.2d 630, 634 (Del. Ch. 1970)* , *rev'd on other grounds, 273 A.2d 264 (Del. 1971)* .

(n90)Footnote 87. Official Constitution and Rules of the New York Stock Exchange, NYSE Rule 452.

(n91)Footnote 88. The Rules of the American Stock Exchange are substantially similar. *See* AMEX Rules 576 and 577.

(n92)Footnote 89. *Berlin v. Emerald Partners, 552 A.2d 482 (Del. 1989)* .

(n93)Footnote 90. *Berlin, 552 A.2d at 494* .

(n94)Footnote 91. *See Berlin, 552 A.2d at 494* . As discussed above, a similar result would obtain under the majority of state statutes providing, as a default rule, that only those shares entitled to vote on a matter should be

counted toward quorum purposes. *See above*.

(n95)Footnote 92. Typical advance notice provisions require 60 to 90 days pre-meeting notice. In contrast, SEC rules generally require that stockholder proposals be included in the company's proxy materials and received at least 120 days before the proxy materials are mailed. *See* Rule 14a-8, question 5.

(n96)Footnote 93. *See, e.g., In re Gaylord Container Corp. S'holders' Litig.*, 753 A.2d 462, 464 (Del. Ch. 2000) (describing advance notice bylaw as one of several "garden-variety defensive measures that gave the board leverage to negotiate with any potential acquiror"); *Henley v. Santa Fe S. Pac. Corp.*, CA 9569, 1988 Del. Ch. LEXIS 32, *16 (Apr. 18, 1988) (characterizing advance notice bylaws adopted coincident with other defensive measures as "antitakeover measures typically taken in anticipation of a proxy contest.").

(n97)Footnote 94. *See, In re Gaylord Container Corp. S'holders' Litig.*, 753 A.2d at 482 (noting that "the fact that an acquiror must make its nomination at least sixty days in advance of the meeting merely lengthens the electoral contest in a way that appears to strike a reasonable balance between the electorate's need to hear out all participants in the debate and the acquiror's need for an adequate opportunity to line up a slate before the meeting"); *see also Stroud v. Grace*, 606 A.2d 75, 95-96 (Del. 1992) (reversing the Court of Chancery; holding that advance notice bylaw was valid absent a showing that it was abused in the context); *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 41-43 (Del. Ch. 1998) (discussing the reasonableness and commonality of advance-notice bylaws); *see also Hubbard v. Hollywood Park Realty Enters., Inc.*, CA 11779, 1991 Del. Ch. LEXIS 9 (Jan. 14, 1991) (noting that a 60-day advance notice provision was facially valid).

(n98)Footnote 94.1. 954 A.2d 335 (Del. Ch. 2008) , *aff'd*, 947 A.2d 1120 (Del. 2008) .

(n99)Footnote 94.2. *Levitt Corp. v. Office Depot Inc*, CA No. 3622, 2008 WL 1724244 (Del. Ch. April 14, 2008) ("Because [the bylaw's] operation is predicated, in part, on what business the Board has chosen to bring before the stockholders' annual meeting in its notice, the provision places a premium on how the Board chooses to describe or limit that business.").

(n100)Footnote 95. *See, e.g., Linton v. Everett*, CA 15219, 1997 Del. Ch. LEXIS 117 (July 31, 1997) ; *Hubbard*, 1991 Del. Ch. LEXIS 9 ; *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906 (Del. Ch. 1980) .

(n101)Footnote 96. *Lerman v. Diagnostic Data, Inc.*, 421 A.2d at 914 .

(n102)Footnote 97. *Linton v. Everett*, 1997 Del. Ch. LEXIS 117 , at **33-35.

(n103)Footnote 98. *See Hubbard*, 1991 Del. Ch. LEXIS 9, at *37 .

(n104)Footnote 99. *Hubbard*, 1991 Del. Ch. LEXIS 9, at *108 n.6 .

(n105)Footnote 100. *See Hubbard*, 1991 Del. Ch. LEXIS 9 , at **37-39.

(n106)Footnote 101. *See Mesa Petroleum Co. v. Unocal Corp.*, CA 7997, 1985 Del. Ch. LEXIS 461 (Apr. 22, 1985) .

(n107)Footnote 102. 63 Fed. Reg. 29,106, 29,118-21.

(n108)Footnote 103. *See Trans World Corp.*, 1981 SEC No-Act LEXIS 3034 (Feb. 5, 1981); *Occidental Petroleum Corp.*, 1984 SEC No-Act LEXIS (Mar. 27, 1984); *Texas Instruments Inc.*, 1982 SEC No-Act LEXIS 1738 (Jan. 19, 1982); *Kiddie Products, Inc.*, 1988 SEC No-Act LEXIS 130 (Jan. 29, 1988) (1988-1990 SEC No-Action Letters Index and Summaries, Washington Service Bureau, Category 74, at 5 [hereinafter "1988-1990 Summaries"]).

(n109)Footnote 104. *See Pioneer Railcorp*, 2002 SEC No-Act LEXIS 346 (Mar. 20, 2002); *Fotoball, Inc.*, 1992

SEC No-Act LEXIS (May 6, 1997); *Citizens Corp.*, 1997 SEC No-Act LEXIS 509 (April 4, 1997); *LSB Industries, Inc.*, 1997 SEC No-Act LEXIS 484 (March 28, 1997).

(n110)Footnote 105. See *Texaco, Inc.*, 2001 SEC No-Act LEXIS 82 (Jan. 16, 2001); *Amerco*, 2000 SEC No-Act LEXIS 756 (July 21, 2000); *SI Handling Systems, Inc.*, 2000 SEC No-Act 629 (May 5, 2000).

(n111)Footnote 106. See *IGEN International, Inc.*, 2000 SEC No-Act LEXIS 711 (July 3, 2000).

(n112)Footnote 107. *Del. Code Ann. tit. 8, § 141(a)*; see also, SEC Release No. 34-12,999, *41 Fed. Reg. 52,994 (1976)*.

(n113)Footnote 108. SEC Release No. 34-12,999, *41 Fed. Reg. 52,994 (1976)*.

(n114)Footnote 109. See Louis Loss and Joel Seligman, *Securities Regulation* § 6-C-4 (3d ed. 1999).

(n115)Footnote 110. SEC Release No. 34-12,999, *41 Fed. Reg. 52,994 (1976)*.

(n116)Footnote 111. See, e.g., R. Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, *18 Yale J. on Reg. 174, 178 (2001)*.

(n117)Footnote 112. See, e.g., *Council of Institutional Investors, Corporate Governance Policies, General Principle C.3*, available at www.cii.org/corp_governance.asp. ("Boards should take actions recommended in shareholder proposals that receive a majority of votes cast for and against.")

(n118)Footnote 113. See, e.g., *Del. Code Ann. tit. 8, § 109*.

(n119)Footnote 114. See, e.g., Lawrence A. Hammermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street*, *73 Tul. L. Rev. 409 (1998)*.

(n120)Footnote 115. *International Bhd. of Teamsters Gen. Fund*, (W.D. Okla. Jan. 24, 1997), *aff'd* after certified question to Oklahoma Supreme Court, *173 F.3d 863 (10th Cir. 1999)* (noting that Oklahoma Supreme Court verified that shareholders could propose resolutions requiring that shareholder rights plans be submitted to the shareholders for vote at the succeeding annual meeting).

(n121)Footnote 116. See, e.g., *Toys "R" Us, Inc.*, 2002 SEC No-Act LEXIS 571 (Apr. 9, 2002) (allowing the issuer to exclude a stockholder proposal to amend the corporation's bylaws to prohibit adoption of a stockholder rights plan without stockholder approval and to redeem the corporation's existing stockholder rights plan); *PLM International, Inc.*, 1997 SEC No-Act LEXIS 575 (Apr. 28, 1997) (allowing the issuer to exclude a stockholder proposal that the company amend its certificate of incorporation to state that the company would not be governed by Section 203 of the Delaware General Corporation Law).

(n122)Footnote 116.1. To do this, the SEC utilized a 2007 amendment to the Delaware constitution authorizing the SEC to certify questions of law to the Delaware Supreme Court. 76 Del. Laws 2007, ch. 37 § 1, effective May 3, 2007.

(n123)Footnote 117. See, e.g., *Pioneer Interest Shares*, 2002 SEC No-Act LEXIS 543 (May 21, 2001); *Hechinger Company*, 1997 SEC No-Act 456 (Mar. 19, 1997); *American Home Prod. Co.*, 1986 SEC No-Act 1801 (Feb. 21, 1986); see also *American Home Prod. Co.*, 1986 SEC No-Act LEXIS 1807 (Feb. 26, 1986).

(n124)Footnote 118. See, e.g., *Johnson & Johnson*, 2000 SEC No-Act LEXIS 14 (Jan. 7, 2000) (allowing the corporation to exclude a proposal requiring the corporation to compensate inventors of products bought or sold by the corporation "to the satisfaction of both parties" by an inventor with a grievance against the corporation); *Mobil Corp.*, 1986 SEC No-Act LEXIS (Jan. 27, 1986) (allowing the company to exclude a proposal that the company amend its termination plan proposed by a former employee who had been contesting the corporation's claim that he was not

eligible for termination benefits).

(n125)Footnote 119. SEC Release No. 34-20,091 (*Aug. 23, 1983*), *48 Fed. Reg. 38,218, 38,220* [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,417 (amending *17 C.F.R. § 240.14a-8*).

(n126)Footnote 120. *See, e.g., Air Express Int'l Corp.*, 1986 SEC No-Act LEXIS 2010 (Apr. 4, 1986); *Texaco Inc.*, 1984 SEC No-Act LEXIS 1846 (Feb. 28, 1984).

(n127)Footnote 121. *See, e.g., General Electric Co., (Surr.)*, 1982 SEC No-Act Lexis 1767 (Jan. 27, 1982) (allowing the corporation to exclude a proposal that would prevent a nuclear weapons manufacturer from maintaining and repairing such weapons on the basis that the resolution would require the corporation to breach an existing obligation).

(n128)Footnote 122. *See, e.g., General Motors Corp.*, 1981 SEC No-Act LEXIS 3260 (Mar. 9, 1981) (finding that a proposal that the corporation determine the number of avowed Communists, Marxists, Leninists, and Maoists on the faculty and staff of a school before making contributions had vague and general objectives).

(n129)Footnote 123. *See, e.g., G.T.E. Corp.*, 1984 SEC No-Act LEXIS 1602 (Jan. 10, 1984) (determining that a company could exclude a proposal stating that "inasmuch as there are many well-qualified women, a number of them should be elected directors," because the election of directors is within the control of the stockholders and the corporation could not ensure the election of any particular director).

(n130)Footnote 124. *See, e.g., JMAR Industries, Inc.*, 1997 SEC No-Act LEXIS 574 (Apr. 30, 1997) (permitting exclusion of proposal to require managers to execute budget and scrutinize plan to achieve specific stock prizes); *Southern Co.*, 1985 SEC No-Act LEXIS 1908 (Mar. 18, 1985) (permitting exclusion of proposal to restrict benefits for certain employees); *Alliant Techsystems Inc.*, 1997 SEC No-Ac LEXIS (Apr. 23, 1997) (refusing to permit exclusion of proposal requiring report to stockholders about company's military contracts because significant public policy issue raised by proposal was distinct from "ordinary business.").

(n131)Footnote 125. *See, e.g., CheckFree Corporation*, 2003 SEC No-Act LEXIS 697 (Sept. 8, 2003) (allowing exclusion, on "ordinary business" grounds, of proposal requesting that the board of directors establish a procedure to enable direct communication between non-management directors and shareholders).

(n132)Footnote 126. SEC Div. of Corp. Fin., Staff Legal Bulletin, *Shareholder Proposals*, July 12, 2002, available at www.sec.gov/interp/legals/csflb14a.htm.

(n133)Footnote 127. *National Semiconductor Corp.*, 2002 SEC No-Act LEXIS 821 (Dec. 6, 2002); *see also Siebel Systems*, 2003 SEC No-Act LEXIS 553 (April 15, 2003) (disagreeing with the company's argument that it could exclude, under the "ordinary business" exclusion, a shareholder proposal requiring the board of directors to adopt and disclose an "Equity Policy" regarding the use of equity in management compensation programs, including certain principles set forth in the proposal).

(n134)Footnote 128. *See, e.g., Imperial Corp. of America*, 1990 SEC No-Act LEXIS 245 (Feb. 12, 1990) (permitting exclusion of stockholder's proposal nominating himself for election to board of directors); *Exxon Mobil Corp.*, 2002 SEC No-Act LEXIS 425 (Mar. 20, 2002) (permitting exclusion of proposal to separate roles of Chairman and CEO and to designate an independent director); *Cirrus Logic, Inc.*, 2000 SEC No-Act LEXIS 741 (July 18, 2000) (permitting exclusion of proposal to hire proxy adversary firm to provide stockholders with analysis of proxy materials); *AT&T Corp.*, 2001 SEC No-Act LEXIS 213 (Feb. 13, 2001) (permitting exclusion of proposal to separate roles of Chairman and CEO).

(n135)Footnote 129. *See, e.g., Executive Industries, Inc.*, 1981 SEC No-Act LEXIS 2770 (June 26, 1981) (permitting exclusion of proposed stock repurchase that conflicted with company's plan of merger); *Firestone Tire and*

Rubber Co., 1979 SEC No-Act LEXIS 2327 (Feb. 21, 1979) (permitting exclusion of proposal to merger or sell assets to a disinterested third-party that conflicted with company's planned merger); *CleveTrust Realty Investors*, 1985 SEC No-Act LEXIS 2805 (Dec. 4, 1985) (permitting exclusion of proposal to reduce percentage of stockholders required to call a special meeting that conflicted with management's proposal to increase the required percentage).

(n136)Footnote 130. See, e.g., *Fluor Corp. (N.Y.C. Teachers' Retirement System)*, 1987 SEC No-Act LEXIS 1575 (Jan. 28, 1987) (permitting exclusion of proposal to cease operations in South Africa when company had already sold its assets and operations there); *The Gap, Inc.*, 2001 SEC No-Act LEXIS 391 (Mar. 16, 2001) (permitting exclusion of proposal for company to study child labor and its suppliers factories when company had already studied the matter and addressed it in a Code of Vendor Conduct).

(n137)Footnote 131. See, e.g., *Motorola, Inc.*, 1987 SEC No-Act LEXIS 1527 (Jan. 7, 1987) (permitting exclusion of proposal to formulate "social, economic and ethical criteria" to apply in military contracts where company had received identical proposal and included it in proxy materials); *The Proctor & Gamble Co.*, 2000 SEC No-Act LEXIS 742 (July 19, 2000) (permitting exclusion of proposal to reinstate annual elections of board of directors, when company had already received similar proposal and included it in proxy materials); *EMCOR Group, Inc.*, 2000 SEC No-Act LEXIS 643 (May 16, 2000) (permitting exclusion of proposal to require stockholder approval of rights plans when company had already received a similar proposal and included it in proxy materials).

(n138)Footnote 132. See, e.g., *Chevron, Inc.*, 1999 SEC No-Act LEXIS 257 (Mar. 4, 1999) (permitting exclusion of proposal where, despite different wording, proposal was substantially similar to prior proposals that never received more than 6 percent of stockholder's votes).

(n139)Footnote 133. See, e.g., *Exelon Corp.*, 2002 SEC No-Act LEXIS 267 (Mar. 2, 2002) (permitting exclusion of proposal to increase dividends by 10 percent); *Whirlpool Corp.*, 1987 SEC No-Act LEXIS 1584 (Feb. 2, 1987) (permitting exclusion of proposal to increase dividend payment ratio to create set range of yield); *Minnesota Mining and Manufacturing Co.*, 2001 SEC No-Act LEXIS 205 (Feb. 10, 2001) (permitting exclusion of proposal to eliminate dividends).



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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.06

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§ 3.06 Special Meetings and Action by Written Consent

[1] Special Meetings

The statutes of most jurisdictions expressly permit stockholders to call special meetings.ⁿ¹ Jurisdictions that statutorily authorize stockholders to call special meetings usually limit this right to situations where holders of a minimum percentage of outstanding shares demand a special meeting.ⁿ² The applicable Delaware statute simply provides that special meetings may be called by the board of directors and by any other persons authorized by either the certificate of incorporation or the by-laws.ⁿ³ Where the charter or by-laws grant a clear and unconditioned right, the directors and officers do not have the discretion to refuse to call a special meeting.ⁿ⁴ Any ambiguities in the charter or bylaws with respect to stockholders' rights to call an annual meeting will be construed in favor of the right.ⁿ⁵ The remedy for a corporation's wrongful failure to call a special meeting is for stockholders to seek a court order compelling the call of the meeting.ⁿ⁶ Relatedly, courts have invalidated action taken at special meetings not called in accordance with the charter or bylaws.ⁿ⁷

A corporation's bylaws may clearly restrict or eliminate the ability of stockholders to call a special meeting. The Delaware courts have approved the adoption of bylaw provisions eliminating the right of stockholders to call special meetings, limiting the right to stockholders owning a particular portion of the corporation's equity, imposing a mandatory time period for the holding of a special meeting following the call by a stockholder, empowering the board to determine the time and place of a stockholder called meeting, and combinations of these provisions.ⁿ⁸ Although statutorily valid, directors must comply with their fiduciary duties when adopting these types of provisions.ⁿ⁹

[2] Action by Written Consent

All jurisdictions currently provide stockholders with the right to act by written consent in lieu of a stockholders' meeting.ⁿ¹⁰ Many states will permit stockholder action in lieu of a meeting only where the stockholders unanimously consent.ⁿ¹¹ Other jurisdictions, like Delaware, permit stockholders to act by written consent to take any action that could be taken at an annual or special meeting, upon the signing and delivery of written consents representing at least the minimum number of votes needed to authorize such action at a meeting in which all shares entitled to vote were cast.ⁿ¹² Generally this means that the holders of a majority of all outstanding shares entitled to vote on a matter can act by written consent. This right can be eliminated or modified only in the certificate of incorporation.ⁿ¹³ Stockholders

may act by written consent without prior notice, although non-consenting stockholders who would otherwise be entitled to vote on the particular matters affected are entitled to "prompt notice" once the consent is effected.ⁿ¹⁴ The delivery of the first written consent starts a sixty day window period, during which a sufficient number of consents to effect the action must be delivered to the corporation.ⁿ¹⁵

While the right to act by written consent was originally granted to eliminate the requirement of a stockholders' meeting where the outcome of the vote would be a foregone conclusion,ⁿ¹⁶ it has been surprisingly important in the takeover context.ⁿ¹⁷ The written consent mechanism is an important tool for a would-be insurgent, as it entails the power to determine the timing of a contest for corporate control, without prior notice to incumbent management.ⁿ¹⁸ In part because of the risks that are perceived to be associated with stockholders having the ability to immediately amend bylaws or oust an incumbent board, the statute has been narrowly construed.ⁿ¹⁹ For example, the statutory requirement that such consents must be signed by "the holders of outstanding stock" has been interpreted as limiting the power to act by written consent to stockholders of record or those acting by proxy for stockholders of record.ⁿ²⁰ Similarly, the technical requirement that each written consent be datedⁿ²¹ has been construed as a strict prerequisite to its efficacy, even where it is clear that the written consents were submitted within the statutory sixty day period.ⁿ²²

As with other aspects of stockholder governance, directors breach their fiduciary duties in taking actions that delay the written consent process for the purpose of entrenching themselves in office.ⁿ²³ For example, in *Datapoint Corp. v. Plaza Sec. Co.*, the Delaware Supreme Court considered the validity of bylaw amendments that created a sixty day waiting period before written consents delivered to the corporation would become effective.ⁿ²⁴ The incumbent board adopted the amendments after being advised of a 10 percent stockholder's intent to acquire control of the company, possibly through a consent solicitation.ⁿ²⁵ Acting upon the advice of counsel, the board adopted the amendments for the admitted purpose of obtaining additional time to "explore alternatives" including the possible distribution of "opposing solicitation material."ⁿ²⁶ Accordingly, the court invalidated the bylaw. While the *Datapoint* Court left open the possibility that bylaws "which would impose minimal essential provisions for ministerial review ..." of consents may be valid,ⁿ²⁷ the Delaware Supreme Court has never upheld a bylaw on this basis.ⁿ²⁸

Apparently in harmony with the Supreme Court's dictum in *Prime Computer*, the Delaware General Corporation Law permits a board of directors to perform the essentially ministerial task of fixing a record date for a consent solicitation.ⁿ²⁹ The board may adopt a resolution setting the record date within the next ten days.ⁿ³⁰ Where the board does not do so, the record date is the date upon which the first valid written consent is delivered to the corporation.ⁿ³¹ The board can preserve its discretion to set the record date by, prior to the delivery of the first valid written consent, adopting a bylaw or charter provision requiring the board to adopt a resolution fixing the record date within a set period after receiving notice of a stockholder's intention to solicit written consents.ⁿ³² Absent such a provision, however, the board loses its discretion to fix a record date upon the delivery of the first written consent.ⁿ³³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsShareholdersMeetings & VotingSpecial MeetingsBusiness & Corporate LawCorporationsShareholdersMeetings & VotingVoting SharesGeneral Overview

FOOTNOTES:

(n1)Footnote 1. *See* Model Bus. Corp. Act § 7.02 at 7-19 (2002 Supp.) (reporting that "[a]ll jurisdictions except Delaware, Kansas, Missouri, Nevada, New York, Oklahoma, and Puerto Rico specifically authorize stockholders to call special meetings.")

(n2)Footnote 2. *See* Model Bus. Corp. Act § 7.02 at 7-19 to 7-20 (2002 Supp.) (reporting that most states have a 10 percent minimum requirement for calling special meetings).

(n3)Footnote 3. *See Del. Code Ann. tit. 8, § 211(d)*. Of course, the corporation's charter or bylaws may authorize

stockholders to call special meetings. *See, e.g., Liese v. Jupiter Corp.*, 241 A.2d 492 (Del. Ch. 1968) .

(n4)Footnote 4. *See generally* Fletcher's Cyclopedia of Corporations § 2000 (2002 Supp); *see also Richman v. DeVal Aerodynamics, Inc.*, 40 Del. Ch. 389, 183 A.2d 569, 572 (Del. Ch. 1962) (granting mandatory injunction ordering company president to call special meeting where requirements in bylaws were satisfied).

(n5)Footnote 5. *See Stengel v. Rotman*, CA 18109, 2001 Del. Ch. LEXIS 22, **17-18 (Feb. 26, 2001) (construing bylaws in favor of stockholders' right to call special meeting to elect directors).

(n6)Footnote 6. *See Young v. Janas*, 34 Del. Ch. 287, 103 A.2d 299, 304 (Del. Ch. 1954) ; *see generally* Fletcher's Cyclopedia of Corporations § 2000 (2002 Supp.).

(n7)Footnote 7. *See, e.g., Young v. Janas*, 34 Del. Ch. 287, 103 A.2d 299, 304 (Del. Ch. 1954) ; *Josephson v. Cosmocolor Corp.*, 31 Del. Ch. 46, 64 A.2d 35, 48 (Del. Ch. 1949) .

(n8)Footnote 8. *See, e.g., In re Gaylord Container Corp. S'holders' Litig.*, 753 A.2d 462 (Del. Ch. 2000) (upholding bylaw amendment eliminating stockholders' ability to call special meetings as one of several related defensive measures); *Mentor Graphics Corp. v Quickturn Design Sys., Inc.*, 728 A.2d 25 (Del. Ch. 1998) , *aff'd*, 721 A.2d 1281 (Del. 1998) (upholding bylaw amendment creating mandatory 90-100 day delay); *Kidsco, Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch. 1995) , *aff'd*, 670 A.2d 1338 (Del. 1995) (upholding bylaw amendment raising minimum delay for special meeting from 35 days to 60 days).

(n9)Footnote 9. *See, e.g., Kidsco, Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch. 1995) , *aff'd*, 670 A.2d 1338 (Del. 1995) .

(n10)Footnote 10. *See* Model Bus. Corp. Act, comm. to § 7.04, at 7-38 (2002 Supp.). Under Delaware law, the removal and replacement of directors by written consent does not obviate the requirement that a corporation hold annual meetings for the election of directors. *See Hoschett v. TSI Int'l Software, Inc.*, 683 A.2d 43 (Del. Ch. 1996) . Directors placed by written consent hold office only until the next annual meeting.

(n11)Footnote 11. *See* Model Bus. Corp. Act Annot., comm. to § 7.04, at 7-38 (2002 Supp.) (noting that 28 jurisdictions, like the relevant Model Act provision, require unanimity).

(n12)Footnote 12. *See Del. Code Ann. tit. 8, § 228(a)*. In 1967, the Delaware statute was amended to eliminate the prior requirement of unanimity. *See* Drexler et al., *Delaware Corporation Law and Practice*, § 31.01 (LexisNexis Matthew Bender).

(n13)Footnote 13. *See Del. Code Ann. tit. 8, § 228(a)*; *see also Allen v. Prime Computer, Inc.*, 540 A.2d 417, 420 (Del. 1988) .

(n14)Footnote 14. *See Del. Code Ann. tit. 8, §§ 228(a), (e)*. The legal consequences of failing to give "prompt notice" after taking written consent are currently uncertain. In the only case to address this issue, *Di Loreto v. Tiber Holding Corp.*, the Court of Chancery suggested that a charter amendment could take effect upon approval and a filing of the amended certificate with the Secretary of State. The court refused to enforce the charter amendment, however, against non-consenting stockholders who did not receive notice of the exercise of written consent for five months, and who had acted in reliance on provisions in the pre-amendment charter. *See Di Loreto v. Tiber*, CA 16564, 1999 Del. Ch. LEXIS 87, **17-18 (June 29, 1999).

(n15)Footnote 15. *See Del. Code Ann. tit. 8, § 228(c)*.

(n16)Footnote 16. *See, e.g., Grynberg v. Burke*, CAs 5198 and 6480, 1981 Del. Ch. LEXIS 487, *18 (Aug. 13, 1981) (stating the written consent procedure is "obviously designed to facilitate shareholder action where the outcome is

a foregone conclusion").

(n17)Footnote 17. *See Allen v. Prime Computer, Inc.*, 540 A.2d 417, 419 (Del. 1988) .

(n18)Footnote 18. *See Drexler, et al., Delaware Corporation Law and Practice*, § 31.01 at 31-2 (2002 Supp.) (explaining that, absent the written consent procedure, incumbent directors would be entitled to focus any control contest around the annual meeting, the timing of which is frequently committed to directors' discretion).

(n19)Footnote 19. *See, e.g., H-M Wexford, LLC v. Encorp, Inc.*, 832 A.2d 129, 152 (Del. Ch. 2003) ; *Grynberg v. Burke*, 1981 Del. Ch. LEXIS 487, *18 (Del. Ch. Aug. 13, 1981) .

(n20)Footnote 20. *See, e.g., Freeman v. Fabinak*, C.A. No. 8035, mem. op. at 19, Hartnett, V.C. (Aug. 15, 1985); *Grynberg v. Burke*, 1981 Del. Ch. LEXIS 487, *18 (Del. Ch. Aug. 31, 1981) .

(n21)Footnote 21. *See Del. Code Ann. tit. 8, § 228(c)*.

(n22)Footnote 22. *See H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 152 (Del. Ch. 2003) .

(n23)Footnote 23. *See, e.g., Allen v. Prime Computer, Inc.*, 540 A.2d 417, 420 (Del. 1988) (stating that "[a] bylaw [affecting the consent process] whose real purpose is delay of shareholder action is *per se* unreasonable") (emphasis added); *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031, 1036 (Del. 1985) (invalidating bylaw delaying the efficacy of written consents that was intended "to provide the incumbent board with *time* to seek to defeat the shareholder action ..."); *accord Edelman v. Authorized Distribution Network, Inc.*, 1989 Del. Ch. LEXIS 156 (Del. Ch. Nov. 3, 1989) (denying summary judgment for plaintiff-stockholders due to material dispute of fact regarding directors' purpose in adopting bylaw).

(n24)Footnote 24. *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031, 1033-34 (Del. 1985) .

(n25)Footnote 25. *Datapoint Corp.*, 496 A.2d at 1033 .

(n26)Footnote 26. *Datapoint Corp.*, 496 A.2d at 1036 .

(n27)Footnote 27. *Datapoint Corp.*, 496 A.2d at 1036 .

(n28)Footnote 28. *See Allen v. Prime Computer, Inc.*, 540 A.2d 417 (Del. 1988) (invalidating bylaw mandating 20 day delay in consent effectiveness, while independent inspectors reviewed and determined the validity of consents submitted); *Cf. In re Damon Corp. S'holders' Litig.*, Federal Securities Law Reporter (CCH) 1988-1989 Transfer Binder P 94,040 at 90,873 (Del. Ch. Sept. 16, 1988) (upholding, without much analysis, advance notice bylaw as reasonable and not in conflict with Section 228).

(n29)Footnote 29. *See Del. Code Ann. tit. 8, § 213(b)*.

(n30)Footnote 30. *See Del. Code Ann. tit. 8, § 213(b)*.

(n31)Footnote 31. *See Del. Code Ann. tit. 8, § 213(b)*.

(n32)Footnote 32. *See Edelman v. Authorized Distribution Network, Inc.*, CA 11104, 1989 Del. Ch. LEXIS 156 , **18-21 (Nov. 3, 1989).

(n33)Footnote 33. *See, e.g., Edelman*, 1989 Del. Ch. LEXIS 156 , **18-19; *see also Midway Airlines, Inc. v. Carlson*, 628 F. Supp. 244, 247 (D. Del. 1985) (applying Delaware law).



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CHAPTER 3 STOCKHOLDERS' RIGHTS

1-3 Corporate Governance: Law and Practice § 3.07

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§ 3.07 Protection of Minority Stockholders

Over time, certain duties, rules, and procedures have been developed to provide some measure of protection to minority stockholders. These duties are grounded in the concept that a controlling stockholder owes fiduciary duties to minority stockholders.

[1] Fiduciary Duty of Controlling Majority Stockholder to Minority

Under Delaware law, controlling stockholders owe fiduciary duties to the corporation and its minority stockholders.ⁿ¹ When a stockholder acquires or owns more than 50 percent of the company's common stock, or otherwise dominates and controls its affairs, the stockholder acquires fiduciary status.ⁿ² It is the "actual exercise of such control, not the simple potential for control, that creates the special duty."ⁿ³ Therefore, if a controlling stockholder takes no action with respect to a transaction involving the corporation, its status as a controlling stockholder alone will not impose a special duty.ⁿ⁴

As a fiduciary, a controlling stockholder owes duties of loyalty, care, and disclosure to the corporation and its minority stockholders. The duty of loyalty requires a controlling stockholder to refrain from acting in a self-interested manner. In the words of the Delaware Supreme Court, "Essentially, the duty of loyalty mandates that the best interest of the corporation and its [stockholders] takes precedence over any interest possessed by a director, officer or controlling [stockholder] and not shared by the stockholders generally."ⁿ⁵ Issues involving the duty of loyalty often arise in business dealings between a controlling stockholder and a corporation due to the possibility that the controlling stockholder may be acting in its own self interest.ⁿ⁶

Because of the potential for self-interested conduct, the Delaware Supreme Court has held repeatedly that "when a controlling stockholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard."ⁿ⁷ The burden to show entire fairness rests on the defendant controlling stockholder. The burden may shift to the plaintiff if a truly independent, disinterested, and informed special committee of outside directors negotiates the transaction on behalf of the minority stockholders.ⁿ⁸

The entire fairness standard of review is composed of two parts: fair dealing and fair price. The fair dealing aspect relates to the process by which the transaction was approved and "embraces the questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained."⁹ Fair price involves the substantive terms of the transaction.¹⁰

A controlling stockholder also owes a limited duty of care to minority stockholders when selling its shares. Although a controlling stockholder generally may sell its block of stock to whomever it chooses and for any price negotiated,¹¹ a controlling stockholder may not intentionally or negligently sell to someone who would loot or otherwise intentionally harm the corporation.

[W]hile a person who transfers corporate control to another is surely not a surety for his buyer, when the circumstances would alert a reasonably prudent person to a risk that his buyer is dishonest or in some material respect not truthful, a duty devolves upon the seller to make such inquiry as a reasonably prudent person would make, and generally to exercise care so that others who will be affected by his actions should not be injured by wrongful conduct.¹²

The Delaware Court of Chancery has assumed without deciding "that a duty of care of a controlling [stockholder] that may in special circumstances arise in connection with a sale of corporate control is breached only by grossly negligent conduct."¹³ A more recent decision, however, suggests that a minority stockholder must "show that the controller acted with scienter and did not simply fail in the due diligence process"¹⁴

A controlling stockholder must also disclose "all material facts and circumstances surrounding the transaction."¹⁵ This duty applies most frequently to controlling stockholders in connection with cash-out mergers and tender offers where appraisal rights or "quasi-appraisal" rights are or will be available.¹⁶ In these circumstances, a stockholder plaintiff may claim that the duty of disclosure was breached because all material information was not disclosed. The duty of disclosure and the steps taken by a controlling stockholder to fulfill its duty also are considered as a component of the "fair dealing" prong of the entire fairness standard.¹⁷

Although a controlling stockholder owes fiduciary duties to the minority stockholders, the controlling stockholder may act in a self-interested manner when acting "qua stockholder."¹⁸ A controlling stockholder can vote its shares in favor or against a transaction for any reason whatsoever: "It is not objectionable that their motives may be for personal profit, or determined by whim or caprice, so long as they violate no duty owed other stockholders."¹⁹ Furthermore, Delaware courts have stated that "[the law] does not, absent a showing of culpability, require that directors or controlling [stockholders] sacrifice their own financial interest in the enterprise for the sake of the corporation or its minority [stockholders]."²⁰ Delaware courts also have recognized that "one who may be both a creditor and a fiduciary (*e.g.*, a director or controlling shareholder) does not by reason of that status alone have special limitations imposed upon the exercise of his or her creditor rights."²¹

[2] All-Holders and Best-Price Rules

Minority stockholders are also protected under federal rules that regulate tender offers. Rule 14d-10(a), promulgated under the 1934 Act, states that "[n]o bidder shall make a tender offer unless: (1) [t]he tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) [t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."²² These rules are commonly known as the all-holders and best-price rules.

Although the rules seem straightforward, interpretation of the best-price rule can be difficult. Most large corporate transactions occur in stages over an extended period. Furthermore, many directors and officers are also stockholders of the corporation. As a result, questions often arose concerning compensation packages that directors and officers were offered in connection with a tender offer. As a result of uncertainty over how compensation arrangements would be

treated under the best-price rule, transaction planners often favored long-form mergers over tender offers to avoid the risk of inadvertently triggering a requirement to pay a higher tender offer price.

In 2006, the SEC amended the best-price rule to clarify that the rule requires only that the consideration paid to any security holder in the tender offer be the highest consideration paid to any other security holder for the securities tendered in the offer. The SEC thus made clear that the intent of the rule was not to require an analysis of payments to employees, directors, or other stockholders of the corporation pursuant to compensation, severance, employee benefit, or other arrangements. The SEC also specifically exempted from the best price rule employment compensation, severance and other employee benefit arrangements entered by the bidder or target company with any holder of securities of the target company, as well as payments made in connection with those arrangements, provided that such payments are being paid for services performed and are not calculated based on the number of shares tendered. The SEC observed that while personnel decisions often are made concurrently with the decision to pursue a transaction, they are generally made independent of the consideration paid for tendered securities.

The amended rule also creates a non-exclusive safe harbor provision excluding compensation, severance and benefit arrangements from the best price rule if these arrangements are approved by the compensation committee of the board of directors of the target company, or a committee performing similar functions. The arrangements also may be approved by the board or a similar committee of the bidder, if the bidder is a party to the arrangement. The board or committee must determine that the payment is being paid and is not calculated based on the number of shares tendered.

[3] Cumulative Voting in Elections of Directors

Cumulative voting increases the voting power of shares by permitting stockholders to accumulate all of the possible votes they could cast for all the directorships to be contested, and then vote them as they wish in favor of (or against) just one or a few candidates.ⁿ²⁵ It reduces the minimum number of votes a stockholder must have to be mathematically assured of electing a director, which number will continue to decrease as the number of directors standing for election increases. Under a cumulative voting regime, the number of shares needed to elect a desired number of directors is roughly determined by (i) multiplying the total number of outstanding shares authorized to vote by the desired number of directors to be elected, (ii) dividing this product by the number that equals the total number of directors standing for election plus one, and (iii) adding one to the quotient (or some fraction of one, where fractional voting of shares is permitted).ⁿ²⁶ Applying this formula reveals that, for example, in an election with five contested directorships, holders of greater than 16.67 percent of the corporations' applicable voting power can be assured of board representation by accumulating votes and casting them for one director.ⁿ²⁷ Under traditional or straight voting, of course, one would need greater than 50 percent of the applicable voting power to be ensured of electing one director.

While several jurisdictions have statutes or constitutional provisions making cumulative voting rights mandatory, the great majority of jurisdictions permit but do not require it.ⁿ²⁸ By statute, Delaware permits cumulative voting to the extent provided for in a company's certificate of incorporation.ⁿ²⁹ Like other provisions in a company's charter, cumulative voting provisions can be repealed, at least where such amendment is not accomplished for an inequitable purpose.ⁿ³⁰ Delaware courts have repeatedly upheld corporate actions that adversely impact minority rights under cumulative voting provisions where such actions are at least arguably in the best interest of the corporation.ⁿ³¹ Yet, so long as a certificate of incorporation provides for cumulative voting, directors cannot be removed without cause where the votes cast against removal, if voted cumulatively, would be sufficient to elect the director at a contested election.ⁿ³² On the other hand, the minority's cumulative voting rights cannot save a director whom the holders of a majority of shares have voted to remove for cause.ⁿ³³

[4] Appraisal Proceedings

Stockholders' appraisal rights refer to minority stockholders' entitlement to receive in cash the fair value of their stock, as determined by a judge on the basis of a factual record developed in litigation, in certain limited circumstances.ⁿ³⁴

Minority stockholders' appraisal rights developed as a statutory remedy to compensate stockholders for the loss of broader common law rights to prevent certain fundamental corporate transactions, which then required unanimous stockholder approval, by simply withholding their consent.ⁿ³⁵ Under Delaware's appraisal statute, stockholders of corporations that are involved in a consolidation or merger are entitled to demand appraisal rights.ⁿ³⁶ Unlike many other jurisdictions, the sale of all or substantially all assets does not trigger appraisal rights under Delaware law.ⁿ³⁷ Upon the perfection of appraisal rights, the traditional rights incidental to the stockholder-company relationship are lost, and the stockholder comes to occupy the position of "a quasi-creditor with a monetary claim" against the corporation.ⁿ³⁸

There are several exceptions to the general rule that appraisal rights are available in a merger or consolidation. Section 262(b)(1) provides in pertinent part:

[N]o appraisal rights under this section shall be available for the shares of any class or series of stock, which stock, or depository receipts in respect thereof, at the record date fixed to determine the stockholders entitled to receive notice of and to vote at the meeting of stockholders to act upon the agreement of merger or consolidation, were either (i) listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc., or (ii) held of record by more than 2,000 holders ...ⁿ³⁹

These so-called "market out" exceptions disallow appraisal rights when stockholders who are dissatisfied with merger consideration will have the viable opportunity to receive "fair value" for their shares through market trades.ⁿ⁴⁰ However, the market out exceptions are inapplicable, and appraisal rights will be available, where a stockholder is required to accept anything other than (a) shares of the surviving corporation, (b) shares of any other corporation meeting the marketability test set forth above, (c) cash in lieu of fractional shares, or some combination of (a)-(c) above.ⁿ⁴¹ Appraisal rights are unavailable to the stockholders of a corporation surviving a merger where, because of the minimal impact of the merger upon existing stockholder interests, no stockholder approval was required for consummation.ⁿ⁴² In statutory "short form" mergers between subsidiaries and parents owning greater than 90 percent of the subsidiaries' voting securities,ⁿ⁴³ the stockholders of the parent corporation do not enjoy appraisal rights, unlike their counterparts in the subsidiary.ⁿ⁴⁴

A dissenting stockholder demanding appraisal rights must demonstrate that he is entitled to an appraisal.ⁿ⁴⁵ Appraisal rights are only available to stockholders of record on the date of the making of the demand for appraisal who continue to be record holders on the effective date of the merger.ⁿ⁴⁶ Furthermore, appraisal rights are only available to stockholders who have not voted in favor or otherwise consented to the merger.ⁿ⁴⁷ A stockholder may pursue appraisal for shares acquired after the announcement of or the record date for the vote on the merger.^{n47.1}

The corporation must notify each stockholder of record that appraisal rights are available at least 20 days prior to the meeting held for a vote on the merger.ⁿ⁴⁸ Such notice must include a copy of Section 262.ⁿ⁴⁹ Where the merger is approved by written consent, or is a "short-form" merger for which no vote is required, the surviving or resulting corporation must provide notice within ten days thereafter.ⁿ⁵⁰

Where a stockholder vote on the merger is required, stockholders may perfect appraisal rights by making a written demand for appraisal prior to the vote.ⁿ⁵¹ Where the merger is effected without a stockholder vote, demands for appraisal must be submitted within 20 days after the notice announcing the transaction.ⁿ⁵² There is no required form for a demand.ⁿ⁵³ By statute, a demand is sufficient if it reasonably informs the corporation of the identity of the stockholder and that the stockholder intends thereby to demand the appraisal of his shares.ⁿ⁵⁴ Submitting a written proxy voting against the merger will not itself suffice for a written demand.ⁿ⁵⁵ Where a dispute arises as to whether the demand suffices to notify the corporation of the intent to seek appraisal, the issue will be whether the writing fairly implies such an intention.ⁿ⁵⁶ The written demand must be signed by the holder of record or joint holders of the shares in order to be effective under the statute.ⁿ⁵⁷ Unlike the liberal and permissive standard to determine whether a demand

gives sufficient notice, the procedural aspects of the statute, including those pertaining to record ownership, are strictly construed.ⁿ⁵⁸

Once made, demands for appraisal may later be withdrawn, with the effect of allowing the stockholder to accept the merger consideration, in certain well-defined circumstances. First, a demand may be withdrawn for a period of 60 days after the effective date of the merger as a matter of right.ⁿ⁵⁹ After the 60 day period, demands may only be withdrawn with the corporation's written consent and with the approval of the court.ⁿ⁶⁰ A purpose of this requirement is to prevent a party to an appraisal action from being induced to abandon the action, through the receipt of a premium settlement offer, to the detriment of the remaining stockholders demanding appraisal.ⁿ⁶¹

If the merger is approved at the meeting, the corporation must send notice that the merger has become effective to each stockholder who has complied with the requirements of Section 262 and has not voted for the merger, within 10 days after the effectiveness of the merger.ⁿ⁶² The stockholder then has 20 days from the date of the mailing of the notice of effectiveness of the merger to demand in writing his appraisal rights.ⁿ⁶³ Within 120 days after the effective date of the merger, the surviving corporation or any stockholder who preserved his appraisal claims may file a petition in the Court of Chancery demanding a determination of the value of the stock of all such stockholders.ⁿ⁶⁴ Within 120 days after the effective date of the merger, upon written request, such stockholder is entitled to receive a statement from the corporation setting forth the aggregate number of shares not voted in favor of the merger and the aggregate number of shares making demands for appraisal.ⁿ⁶⁵

The corporation cannot modify the time periods specified in Section 262. Delaware courts have indicated that, since stockholders are required to strictly comply with the formalities of Section 262 when seeking to exercise their appraisal rights, corporations should be held to the same standard.ⁿ⁶⁶

Stockholders who vote for or otherwise consent to a merger forfeit their appraisal rights.ⁿ⁶⁷ However, it is not necessary for a stockholder to vote against the proposed merger.ⁿ⁶⁸ Courts generally look at the actions of the holder of record when determining whether a stockholder is entitled to an appraisal. Therefore, if the record holder tenders its shares and accepts the merger consideration, the beneficial holder of the shares may lose his right to an appraisal even where the beneficial owner submits a demand to the corporation.ⁿ⁶⁹ Holders of non-voting stock who properly dissent from a transaction are entitled to the same appraisal remedy afforded to dissenting holders of voting shares.ⁿ⁷⁰ The appraisal rights of stockholders who split their holdings and vote some shares in favor of the merger while withholding consent as to others has yet to be determined.ⁿ⁷¹ The Court of Chancery upheld a stockholder's decision to withdraw an appraisal demand with regards to some, but not all, of the shares covered under the demand.ⁿ⁷² The court reasoned that the literal terms of the statute did not preclude the partial withdrawal, which in any event had the benefit of permitting stockholders' use of the merger consideration received in exchange for tendering some shares in order to defray the costs of an appraisal proceeding.ⁿ⁷³

The final step in perfecting appraisal rights is the filing of a petition in the Court of Chancery demanding a valuation with respect to all stockholders and shares seeking to exercise their appraisal rights. Either the corporation or any stockholder seeking appraisal may submit the petition, which must be filed within 120 days after the effective date of the merger.ⁿ⁷⁴ Either coincident with its filing of the petition, or within 20 days after being served by a stockholder-filed petition, the corporation must file a verified list of the names and addresses of stockholders seeking appraisal rights.ⁿ⁷⁵ Due to the narrow scope of an appraisal proceeding, the corporation's answer to the petition may not assert counterclaims unrelated to the petition.ⁿ⁷⁶ The Delaware courts previously held that only a holder of record could file an appraisal petition under § 262,ⁿ⁷⁷ but in 2007 the legislature made it clear that a beneficial owner could also file an appraisal petition or request a statement of shares with respect to which demands for appraisal have been received.ⁿ⁷⁸

A hearing is then held to determine the stockholders who have submitted proper and timely demands.ⁿ⁷⁹ Each stockholder seeking appraisal bears the burden of proving compliance with the statutory requirements.ⁿ⁸⁰ With respect

to all stockholders making proper appraisal demands, the proceeding is in the nature of a class suit to determine the value to be paid by the corporation.ⁿ⁸¹ Like a class action plaintiff, a stockholder filing the petition stands in a fiduciary relationship to other stockholders seeking appraisal.ⁿ⁸²

Strict compliance with the statutory prerequisites is required. For example, failure of a stockholder demanding appraisal to comply with filing deadlines provides the corporation with a valid defense to the appraisal claim regardless of whether the corporation is proximately harmed by the lack of statutory notice.ⁿ⁸³

After the court determines which shares qualify for participation in the appraisal proceeding, the value of the respective shares must be determined. Delaware courts have "recognized that there is no one exclusive means of assigning value to a Delaware corporation for purposes of an appraisal."ⁿ⁸⁴ Although the valuation of a particular stock will vary according to the peculiar facts of a case, Section 262 requires a determination of value isolated from any transactional effects.ⁿ⁸⁵ Thus, "[f]uture value that would not exist but for the merger cannot ... accurately be said to have been taken from a dissenting stockholder in the merger, even if it is capable of being proven on the date of the merger."ⁿ⁸⁶ Section 262(h) states the standard for appraisal as follows:

[T]he Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.ⁿ⁸⁷

The Court of Chancery thus has an obligation to consider all relevant factors in appraising the value of stock held by dissenters.ⁿ⁸⁸

As explained by the Delaware Supreme Court, the "basic concept" of fair value is that "the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern," taking into account all factors and elements, including a corporation's future prospects, that reasonably bear on its true value.ⁿ⁸⁹ The Court of Chancery has broad discretion in this regard and may choose to adopt any valuation method offered by the parties, or may use any other method as it deems appropriate.ⁿ⁹⁰ Asset value, market value, earnings, future prospects of the corporation and "any other elements that affect the intrinsic or inherent value" of the appraised stock may be considered.ⁿ⁹¹ Where the merger results from arms' length negotiations and an open bidding process, the merger consideration (minus any sums attributable to anticipated post-merger synergies) may itself be the best indicator of fair value.ⁿ⁹²

Delaware courts have explained the burden of proof in an appraisal action as follows:

In an appraisal action, each side has the burden of proving its respective valuation position. No presumption, favorable or unfavorable, attaches to either side's valuation, including the actual merger price. Because no determination of 'liability' is required to obtain relief under § 262, and since neither side is benefitted or burdened by any presumption, the burden of proof in an appraisal action should be the same as in any normal civil action, i.e., proof by a preponderance of the evidence.ⁿ⁹³

In the event that none of the parties establishes a value satisfactory to the court, the court must make such a determination based upon its own analysis.ⁿ⁹⁴

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsShareholdersAppraisal & Dissent RightsGeneral OverviewBusiness & Corporate LawCorporationsShareholdersMeetings & VotingVoting SharesDirector Elections & RemovalsBusiness &

Corporate Law Corporations Shareholders Shareholder Duties & Liabilities Controlling Shareholders Fiduciary Responsibilities Securities Law Additional Offerings & the Securities Exchange Act of 1934 Tender Offers General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Tender Offers Best Price Rule

FOOTNOTES:

(n1)Footnote 1. *See, e.g., COPI of Delaware, Inc. v. Kelly*, 1996 Del. Ch. LEXIS 136 (Del. Ch. Oct. 25, 1996), *aff'd sub nom., Smart Bus. Sys. v. COPI of Delaware, Inc.*, 707 A.2d 767 (Del. 1998).

(n2)Footnote 2. *See, e.g., Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1113 (Del. 1994).

(n3)Footnote 3. *Citron v. Steego Corp.*, CA 10171, 1988 Del. Ch. LEXIS 119, *16 (Sept. 9, 1988).

(n4)Footnote 4. *Cinerama, Inc. v. Technicolor, Inc.*, CA 8358, 1991 Del. Ch. LEXIS 105 (June 24, 1991), *aff'd in part & rev'd in part*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

(n5)Footnote 5. *Cede & Co. v. Technicolor*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

(n6)Footnote 6. *See, e.g., Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1116-1117 (Del. 1994).

(n7)Footnote 7. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997). *See also Kahn*, 638 A.2d at 1115; *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985); *In re MAXXAM, Inc./Federated Development Stockholders Litig.*, CAs 12111 and 12353, 1997 Del. Ch. LEXIS 51 (Apr. 4, 1997).

(n8)Footnote 8. *See, e.g., Kahn*, 638 A.2d at 1117.

(n9)Footnote 9. *In re MAXXAM, Inc./Federated Development Stockholders Litig.*, 1997 Del. Ch. LEXIS 51, *43 (Apr. 4, 1997).

(n10)Footnote 10. *In re MAXXAM, Inc.*, 1997 Del. Ch. LEXIS 51.

(n11)Footnote 11. *Amsellem v. Shopwell, Inc.*, CA 5683, 1979 Del. Ch. LEXIS 479 (Sept. 6, 1979).

(n12)Footnote 12. *Harris v. Carter*, 582 A.2d 222, 235 (Del. Ch. 1990).

(n13)Footnote 13. *Harris*, 582 A.2d at 235-236.

(n14)Footnote 14. *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 759 (Del. Ch. 2006).

(n15)Footnote 15. *Kahn v. Tremont Corp.*, 694 A.2d 422, 431 (Del. 1997).

(n16)Footnote 16. *See, e.g., Shell Petroleum, Inc. v. Smith*, 606 A.2d 112 (Del. 1992); *Kahn v. Household Acquisition Corp.*, 591 A.2d 166 (Del. 1991); *Gilliland v. Motorola, Inc.*, 873 A.2d 305 (Del. Ch. 2005).

(n17)Footnote 17. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983), *aff'd*, 497 A.2d 792 (Del. 1985).

(n18)Footnote 18. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840 (Del. 1987).

(n19)Footnote 19. *Bershad*, 535 A.2d at 845.

(n20)Footnote 20. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 598 (Del. Ch. 1986).

(n21)Footnote 21. *Odyssey Partners L.P. v. Fleming Co.*, C.A. 14770, 1996 WL 422377, at *3 (Del. Ch. July 24, 1996).

(n22)Footnote 22. *17 C.F.R. § 240.14d.10(a)*.

(n23)Footnote 25. *See generally* Fletcher's *Cyclopedia of Corporations* § 2048 (2002 Supp.).

(n24)Footnote 26. *See generally* R. Franklin Balotti & Jesse A. Finkelstein, 1 *The Delaware Law of Corporations and Business Organizations*, § 7.27 at 7-51 (2002 Supp.).

(n25)Footnote 27. *See* Lewis D. Solomon & Alan R. Palmiter, *Corporations: Examples and Explanations*, § 7.3.2 at 123 (3d. ed 1999).

(n26)Footnote 28. *See* Model Bus. Corp. Act comm. to § 7.28 at 7-192 (2002 Supp.) (listing states with mandatory and optional cumulative voting rights).

(n27)Footnote 29. *See Del. Code Ann. tit. 8, § 214*.

(n28)Footnote 30. *See Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 A. 255, 256-57 (Del. Ch. 1929)* (reasoning, *inter alia*, that minority stockholders are presumed to know of the possibility that the company's charter may be amended, and that charter amendments eliminating cumulative voting do not discriminate against particular stockholders, but only affect rights incident to stock ownership).

(n29)Footnote 31. *See, e.g., AAR Corp. v. Brooks & Perkins, Inc., CA 6287, 1980 Del. Ch. LEXIS 617, **3-9* (Oct. 22, 1980) (upholding incumbent board's right to reduce number of directors to be elected, with the effect of negating cumulative voting rights, where minority candidate's election might cause corporation to government subsidy); *Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 A. 255, 256 (Del. Ch. 1929)* (upholding right of majority to eliminate cumulative voting provision where minority board representation would prejudice the corporation in litigation against minority stockholders).

(n30)Footnote 32. *See Del. Code Ann. tit. 8, § 141(k)(2)*.

(n31)Footnote 33. *See Campbell v. Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852, 858 (Del. Ch. 1957)* ; *Cf.* Model Bus. Corp. Act § 8.08(c) and comm. thereto (2002 Supp.) (refusing to acknowledge the right of a majority of stockholders to remove a director for cause).

(n32)Footnote 34. *See generally* Drexler et al., *Delaware Corporation Law and Practice*, § 36.01 (2003 Supp.).

(n33)Footnote 35. *See Schenley Indus., Inc. v. Curtis, 38 Del. Ch. 370, 152 A.2d 300, 301-02 (Del. 1959)* .

(n34)Footnote 36. *See Del. Code Ann. tit. 8, § 262*.

(n35)Footnote 37. *Compare Hariton v. Arco Electronics, Inc., 40 Del. Ch. 326, 182 A.2d 22, 25-26 (Del. Ch. 1962)* , *aff'd*, 41 Del. Ch. 74, 188 A.2d 123 (Del. 1963) ; *and* Model Bus. Corp. Act § 13.02 and comm. (2002 Supp.) (providing for appraisal rights for asset sale and reporting that more than 40 jurisdictions provide similarly).

(n36)Footnote 38. *Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 258 (Del. 1995)* .

(n37)Footnote 39. *Del. Code Ann. tit. 8, § 262(b)(1)*.

(n38)Footnote 40. *See generally Applebaum v. Avaya, Inc., 812 A.2d 880, 890 & n. 29 (Del. 2002)* (citing "market-out" exceptions in support of the proposition that "a property interest is best valued by the amount a buyer will pay for it").

(n39)Footnote 41. *Del. Code Ann. tit. 8, § 262(b)(2)*; *see also Klotz v. Warner Communs., 674 A.2d 878, 879-80 (Del. 1995)* .

(n40)Footnote 42. *See Del. Code Ann. tit. 8, § 262(b)(2); Del. Code Ann. tit. 8, § 251(f).*

(n41)Footnote 43. *See § 3.02[1][b] above.*

(n42)Footnote 44. *Del. Code Ann. tit. 8, § 262(b)(3); Del. Code Ann. tit. 8, § 253(d).*

(n43)Footnote 45. *Neal v. Alabama By-Products Corp., CA 8282, 1988 Del. Ch. LEXIS 135 (Oct. 11, 1988).*

(n44)Footnote 46. *Del. Code Ann. tit. 8, § 262(a).*

(n45)Footnote 47. *Del. Code Ann. tit. 8, § 262(a).*

(n46)Footnote 47.1. *See In re Appraisal of Transkaryotic Therapies, Inc., C.A. No. 1554-CC (Del. Ch. May 2, 2007).*

(n47)Footnote 48. *Del. Code Ann. tit. 8, § 262(d)(1).*

(n48)Footnote 49. *Del. Code Ann. tit. 8, § 262(d)(1).* The inadvertent failure to include a copy of Section 262 in the notice has been held to be a *per se* breach of the fiduciary duty of disclosure, which may permit stockholders who previously tendered their shares in exchange for the merger consideration to submit appraisal demands. *Nebel v. Southwest Bancorp, Inc., CA 13618, 1995 Del. Ch. LEXIS 80, **17-18 (July 5, 1995)* (explaining that "our law requires that the statutory mandate be strictly observed, and contemplates that any nonobservance will give rise to an appropriate remedy.").

(n49)Footnote 50. *See Del. Code Ann. tit. 8, § 262(d)(1).*

(n50)Footnote 51. *Del. Code Ann., tit. 8, § 262(d)(1).*

(n51)Footnote 52. *Del. Code Ann. tit. 8, § 262(d)(1).*

(n52)Footnote 53. *See, e.g., Sapala v. Forest Health Serv. Corp., CA 14260, 1996 Del. Ch. LEXIS 48, **5-6 (Jan. 26, 1996)* (so stating).

(n53)Footnote 54. *Del. Code Ann. tit. 8, § 262(d)(1).*

(n54)Footnote 55. *Del. Code Ann. tit. 8, § 262(d)(1).*

(n55)Footnote 56. *See, e.g., Abraham & Co. v. Olivetti Underwood Corp., 42 Del. Ch. 95, 204 A.2d 740, 742 (Del. Ch. 1964), aff'd sub nom, 42 Del. Ch. 588, 217 A.2d 683 (Del. 1966).*

(n56)Footnote 57. *See Del. Code Ann. tit. 8, § 262(a)* (defining "stockholder" as a "holder of record"); *see also Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254 (Del. 1995).*

(n57)Footnote 58. *See Nelson v. Frank E. Best, Inc., 768 A.2d 473, 480 & n. 29 (Del. Ch. 2000)* (reviewing and harmonizing cases suggesting liberal or strict construction of Section 262).

(n58)Footnote 59. *Del. Code Ann. tit. 8, § 262(e); see also Nagy v. Bistricher, 770 A.2d 43, 63 (Del. Ch. 2000).*

(n59)Footnote 60. *Del. Code Ann. tit. 8, § 262(k).*

(n60)Footnote 61. *See, e.g., Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 261-62 (Del. 1995); see generally Rolland v. CBA Intern, Inc. I, C.A. No. 14264 (May 5, 1997)* (assuming without deciding that parties to appraisal proceeding would be entitled to amount received by non-parties' appraisal demands).

- (n61)Footnote 62. *Del. Code Ann. tit. 8, § 262(d)(1)*.
- (n62)Footnote 63. *Del. Code Ann. tit. 8, § 262(d)(2)*.
- (n63)Footnote 64. *Del. Code Ann. tit. 8, § 262(e)*.
- (n64)Footnote 65. *Del. Code Ann. tit. 8, § 262(e)*.
- (n65)Footnote 66. *Jackson v. Turnbull*, CA 13042, 1994 *Del. Ch. LEXIS 25* (Feb. 8, 1994) .
- (n66)Footnote 67. *Del. Code Ann. tit. 8, § 262(a)*.
- (n67)Footnote 68. *Lewis v. Corroon & Reynolds Corp.*, 30 *Del. Ch. 200*, 57 A.2d 632 (*Del. Ch. 1948*) .
- (n68)Footnote 69. *LeCompte v. Oakbrook Consol. Inc.*, CA 80828, 1986 *Del. Ch. LEXIS 374* (Mar. 7, 1986) .
- (n69)Footnote 70. *Del. Code Ann. tit. 8, § 262(b)*.
- (n70)Footnote 71. *See Olivetti Underwood Corp. v. Jacques Coe & Co.*, 42 *Del. Ch. 588*, 217 A.2d 683, 687 (*Del. 1966*) .
- (n71)Footnote 72. *See The Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 2003 *Del. Ch. LEXIS 136* , **71-76 (Jan. 5, 2004).
- (n72)Footnote 73. *See The Union Illinois 1995 Inv. Ltd. P'ship*, 2003 *Del. Ch. LEXIS 136* at *75 ; *see also Olivetti Underwood Corp. v. Jacques Coe & Co.*, 42 *Del. Ch. 588*, 217 A.2d 683, 687 (*Del. 1966*) (construing statute, finding "no valid reason ... which would bar a stockholder from 'hedging' his position by electing to accept the offered price as to some of his stock and demanding appraisal as to the rest").
- (n73)Footnote 74. *See Del. Code Ann. tit. 8, § 262(e)*.
- (n74)Footnote 75. *See Del. Code Ann. tit. 8, § 262(f)*. The fact that a corporation has filed the list will not act as an admission, or otherwise estop it from challenging the listed stockholders' entitlement to an appraisal. *See In re Universal Pictures Co.*, 28 *Del. Ch. 72*, 37 A.2d 615, 622-23 (*Del. Ch. 1944*) .
- (n75)Footnote 76. *Hendrickson v. Specialty Bakers, Inc.*, C.A. No. 7902 (*Del. Ch. Oct. 22, 1985*).
- (n76)Footnote 77. *In re Appraisal of Transkaryotic Therapies, Inc.*, C.A. No. 1554-CC (*Del. Ch. May 2, 2007*).
- (n77)Footnote 78. 76 *Del. Laws 2007*, ch. 145, §§ 11-16, eff. July 17, 2007.
- (n78)Footnote 79. *See Del. Code Ann. tit. 8, § 262(g)*.
- (n79)Footnote 80. *See In re Universal Pictures Co.*, 28 *Del. Ch. 72*, 37 A.2d 615 (*Del. Ch. 1944*) .
- (n80)Footnote 81. *See, e.g., Lutz v. A.L. Garber Co.*, 357 A.2d 746, 748-49 (*Del. Ch. 1976*) .
- (n81)Footnote 82. *See In re Appraisal of Shell Oil Co.*, CA No. 8080 (*Del. Ch. Nov. 30, 1988*).
- (n82)Footnote 83. *Schneyer v. Shenandoah Oil Corp.*, 316 A.2d 570 (*Del. Ch. 1974*) .
- (n83)Footnote 84. *Rapid-Am. Corp. v. Harris*, 603 A.2d 796, 805 (*Del. 1992*) .
- (n84)Footnote 85. *Del. Code Ann. tit. 8, § 262(h)*.

(n85)Footnote 86. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 296 (Del. 1996) (quotation omitted).

(n86)Footnote 87. *Del. Code Ann. tit. 8, § 262(h)*.

(n87)Footnote 88. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983) .

(n88)Footnote 89. *Tri-Continental Corp. v. Battye*, 31 Del. Ch. 523, 74 A.2d 71, 72 (Del. 1950) .

(n89)Footnote 90. *See, e.g., Cede & Co.*, 684 A.2d at 299-300 .

(n90)Footnote 91. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) .

(n91)Footnote 92. *See The Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 2004 Del. Ch. LEXIS 136 , **45-46 (Jan. 5, 2004).

(n92)Footnote 93. *Pinson v. Campbell Taggart, Inc.*, CA 7499, 1989 Del. Ch. LEXIS 50, *19-20 (Feb. 28, 1989) .

(n93)Footnote 94. *Cooper v. Pabst Brewing Co.*, CA 7244, 1993 Del. Ch. LEXIS 91 (June 8, 1993) .



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Corporate Governance: Law and Practice

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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice 4.syn

AUTHOR: J. Travis Laster

§ 4.syn Synopsis to Chapter 4: LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

§ 4.01 The Business of the Corporation "Shall Be Managed by or Under the Direction of a Board of Directors"

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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.01

AUTHOR: J. Travis Laster

§ 4.01 The Business of the Corporation "Shall Be Managed by or Under the Direction of a Board of Directors"

It is universally recognized that the board of directors is vested with the ultimate power and duty to manage the business of the corporation. The Model Business Corporation Act provides that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its ... [the company's] board of directors"n1 The American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* applies a comparable concept: "The board of directors of a publicly held corporation should ... [m]anage the business of the corporation"n2 The corporation laws of all fifty states address the powers and duties of directors.n3 The Delaware General Corporation Law provides, "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation"n4 The remainder of this chapter will focus on, and all section references will refer to, the Delaware General Corporation Law.

The phrase "business and affairs of every corporation"n5 has been interpreted to grant extremely broad powers to the board of directors. This broad grant of authority reflects the underlying policy that "directors, not shareholders, are charged with the duty to manage the firm."n6 Directors' managerial prerogatives include the power to devise a plan for the corporate enterprise and to select a time frame for the achievement of corporate goals.n7 This includes the power to control all the various tasks associated with running a public corporation, such as deploying capital and making investments,n8 devising a marketing strategy,n9 and paying dividends.n10 Directors are similarly empowered in decisions regarding matters of fundamental importance to the corporate enterprise. In the takeover context, for example, the board has broad power and authority, as well as a concomitant duty, to determine and implement a course of action that is in the corporation's best interests.n11 In the merger context, the directors are similarly empowered to choose a merger partner for the corporation.n12

Although the Delaware General Corporation Law grants broad powers to the board of directors, the stockholders must make the final decision in some matters of great importance. For example, a board cannot alter the fundamental governing documents of the corporation (i.e., the certificate of incorporation and by-laws) without some form of stockholder approval. At most, the board can recommend changes to the certificate of incorporation for stockholder approval.n13 The board of directors only has the power to adopt, amend, or alter the corporation's by-laws if the stockholders previously granted the directors that power in the certificate of incorporation, and the grant of this power

to the board of directors in no way limits the stockholders' power to adopt, amend, or repeal by-laws.ⁿ¹⁴ For certain other matters of fundamental corporate importance, such as mergers, liquidations, and sales of all or substantially all assets, the stockholders have the ultimate discretion to approve or veto the board's recommendations.ⁿ¹⁵ But even where stockholders have the final say, only the board has the power to initiate such changes via formal resolution.ⁿ¹⁶ The only exceptions to the general rule requiring board action are that shareholders unilaterally may dissolve the corporation,ⁿ¹⁷ amend the by-laws,ⁿ¹⁸ and effect a short-form merger.ⁿ¹⁹

The duties conferred under Section 141(a) have been construed to prevent a board of directors from limiting its fiduciary responsibilities. In *Quickturn Design Systems, Inc. v. Shapiro*, for example, the Delaware Supreme Court held that a delayed redemption provision in a stockholder rights plan, also known as a "slow hand" poison pill, was invalid.ⁿ²⁰ The provision purported to limit newly elected directors from redeeming the poison pill for a period of six months. The court explained that "Section 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation."ⁿ²¹ Because there was no applicable provision in Quickturn's charter, the delayed redemption provision was invalid because Section 141(a) "confers upon any newly elected board of directors full power to manage and direct the business and affairs of a Delaware corporation."ⁿ²²

The holding in *Quickturn*, however, should be contrasted with the Court of Chancery's decision in *UniSuper Ltd. v. News Corp.*ⁿ²³ In *Unisuper*, several institutional stockholders brought suit to enforce a company's alleged agreement to submit the decision to renew the company's poison pill to a stockholder vote. The company argued that the agreement would be invalid under Section 141(a). The court disagreed, stating that the agreement did not violate Section 141(a) because it ceded the board's power to the stockholders rather than a third party.ⁿ²⁴

Another one of the obligations created by the broad statutory grant of authority to directors is that directors may not abdicate their management responsibilities or delegate them wholesale to others.ⁿ²⁵ Directors abdicate their management responsibilities when they render themselves unable to exercise independent business judgment with regard to the matter at issue.ⁿ²⁶ For this reason, a director may not act by proxy.ⁿ²⁷ Directors also may not delegate duties assigned to the board of directors by statute.ⁿ²⁸ For example, a board may not delegate to officers of the corporation complete authority to negotiate, fix the final terms of, and conclude a binding agreement for the sale of all or substantially all of the corporation's assets.ⁿ²⁹ Directors may, however, direct officers or agents of the corporation to carry out tasks under the supervision and control of the board, including the day-to-day management of the corporation or negotiation of terms of significant agreements subject to board approval.ⁿ³⁰ As discussed in the next section, the board of directors also may delegate tasks and authority to committees of the board.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityLimitationsBusiness & Corporate LawCorporationsShareholdersMeetings & VotingVoting SharesFundamental Changes

FOOTNOTES:

(n1)Footnote 1. Model Bus. Corp. Act § 8.01(b).

(n2)Footnote 2. American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 3.02 (1994).

(n3)Footnote 3. Jonathan R. Macey, Macey on Corporation Laws § 16.01(B) (1998).

(n4)Footnote 4. *Del. Code Ann. tit. 8, § 141(a)* (2003).

(n5)Footnote 5. *Del. Code Ann. tit. 8, § 141(a)* (2003).

(n6)Footnote 6. *Paramount Communications Inc. v. Time Inc., Consol., 1989 Del. Ch. LEXIS 77, at *89 (July 14, 1989)*, *aff'd*, 571 A.2d 1140, 1154 (Del. 1989) (citing Section 141(a) in support of the premise that "Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives"); *see also Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (citing Section 141(a) for the proposition that "[a] cardinal precept of the Delaware General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation"); *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281, 1291 (Del. 1998) (citing Section 141(a) for the proposition that "[o]ne of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation").

(n7)Footnote 7. *See Paramount Communications, Inc. v. Time Inc., Consol., 1989 Del. Ch. LEXIS 77, at *89 (July 14, 1989)*, *aff'd*, 571 A.2d 1140 1154 (Del. 1989).

(n8)Footnote 8. *See Gagliardi v. Trifoods Int'l*, 683 A.2d 1049, 1059 (Del. Ch. 1996) ("The business outcome of an investment project that is unaffected by director self-interest or bad faith cannot itself be an occasion for director liability. That is the hard core of the business judgment doctrine.") (footnote omitted).

(n9)Footnote 9. *Ross Sys. Corp. v. Ross*, CA 10378, 1993 Del. Ch. LEXIS 35, *63 (Feb. 19, 1993) (upholding corporation's practice of sending free product samples to good customers, stating "[t]hat a corporation may promote its products to carry on its business, and for that purpose may expend such amounts as its managers in their business judgment deem appropriate, is beyond dispute").

(n10)Footnote 10. *See, e.g., Mendel v. Carroll*, 651 A.2d 297, 307 (Del. Ch. 1994) (stating "It is elementary that the declaration of dividends out of available corporate funds is a matter left to the discretion of the board of directors."); *accord Del. Code Ann. tit. 8, § 170* (2003).

(n11)Footnote 11. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953 (Del. 1985) (citing Section 141(a) in support of directors' power to enact defensive measures in response to perceived threat, noting directors' "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceive, irrespective of its source"); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1353 (Del. 1985) (stating that Section 141(a) provides a board of directors with the authority to adopt a stockholder rights plan); *Revlon, Inc. v. Mac Andrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) (citing Section 141(a) in support of directors' prerogative during merger negotiations, including the adoption of a poison pill rights plan to give leverage). *See generally* Chapter 12 *below*, discussing governance and directors' duties in the corporate control context.

(n12)Footnote 12. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 115-52 (Del. 1989).

(n13)Footnote 13. *See Del. Code Ann. tit. 8, § 242* (2003).

(n14)Footnote 14. *Del. Code Ann. tit. 8, § 109* (2003).

(n15)Footnote 15. *See Del. Code Ann. tit. 8, §§ 251 and 271* (2003).

(n16)Footnote 16. *See Del. Code Ann. tit. 8, §§ 242, 251 and 271* (2003).

(n17)Footnote 17. *Del. Code Ann. tit. 8, § 275(c)* (2003).

(n18)Footnote 18. *Del. Code Ann. tit. 8, § 109* (2003).

(n19)Footnote 19. *Del. Code Ann. tit. 8, § 253* (2003).

(n20)Footnote 20. 721 A.2d 1281 (Del. 1998).

(n21)Footnote 21. *Quickturn Design Systems*, 721 A.2d at 1291 .

(n22)Footnote 22. *Quickturn Design Systems*, 721 A.2d. at 1292 ; see also *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (invalidating a "dead hand" rights plan); *Bank of N.Y. v. Irving Bank Corp.*, 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988) (invalidating a dead hand right plan provision under New York law); but see *Invacare Corp. v. Healthdyne Techs. Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997) (stating that a deal hand pill was permissible under Delaware law).

(n23)Footnote 23. *UniSuper Ltd.*, (Del. Ch. Dec. 20, 2005) .

(n24)Footnote 24. See also *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007) (finding directors could enter agreement with shareholder limiting the corporation's ability to issue equity).

(n25)Footnote 25. *Clarke Mem'l Coll. v. Monaghan Land Co.*, 257 A.2d 234, 241 (Del. Ch. 1969) .

(n26)Footnote 26. See *Chapin v. Benwood Foundation, Inc.*, 402 A.2d 1205, 1209-1211 (Del. Ch. 1979) (holding trustees of non-stock charitable corporation could not enter into binding agreement to fill board vacancies with specified nominees, as this would abdicate their responsibility to use independent business judgment in filling vacancies); *Abercrombie v. Davies*, 123 A.2d 893 (Del. Ch. 1956) (invalidating binding agreement whereby directors would be required to vote in accordance with wishes of appointing stockholder), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957) ; *Field v. Carlisle Corp.*, 68 A.2d 817, 819-821 (Del. Ch. 1949) (holding board's binding offer to acquire shares of third party in exchange for an amount of corporation's stock to be determined by a third-party appraiser invalidly delegated statutory duty to determine value of and consideration for issued stock).

(n27)Footnote 27. *Lippman v. Kehoe Stenograph Co.*, 95 A. 895 (Del. Ch. 1915) ("A director may not vote by proxy, because his personal judgment is necessary, and he cannot delegate his duties, or assign his powers.").

(n28)Footnote 28. See, e.g., *Rosenblatt v. Getty Oil Co.*, No. 5278, 1983 Del. Ch. LEXIS 570, at *49 (Sept. 19, 1983) (holding that "directors cannot lawfully agree to surrender to others the duties of corporate management which the statutes impose upon them," but concluding that board's use of third-party valuation of subsurface assets in merger negotiations did not violate this rule).

(n29)Footnote 29. *Clarke Mem'l Coll. v. Monaghan Land Co.*, 257 A.2d 234, 241 (reasoning that "what the officers deem to be in the best interest of the Corporation is not necessarily what the Board of Directors may decide is in its best interest").

(n30)Footnote 30. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 943 (Del. Ch. 1985) ; see also *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d. 27, 69 (Del. 2006) (concluding that the board and the chief executive officer had concurrent authority to terminate the employment of the company's president). Officers of a corporation owe the same fiduciary duties as directors. *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) .



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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.02

AUTHOR: J. Travis Laster

§ 4.02 The Board's Authority to Delegate to a Committee and the Use of Committees under State Law

Boards of directors frequently delegate tasks and functions to committees. Depending on the scope of the grant of authority to the committee, the committee can wield many of the powers of the board in the management of the business and affairs of the corporation and potentially act for the whole board on matters that fall within the committee's delegated area of responsibility. Common board committees include the executive committee, finance committee, audit committee, compensation committee, nominating committee, and with growing frequency, the corporate governance and nominating committee.ⁿ¹ Detailed discussions of the required and recommended composition, scope of responsibilities, charters, and procedures of the nominating and corporate governance committee, the audit committee and the compensation committee, may be found in Chapters 8, 9, and 10 *below*. In instances where a board utilizes committees, particularly audit and compensation committees, the committees may perform the board's task of monitoring the management of the corporation. Such committees should be comprised primarily of non-management directors.ⁿ² Under the Sarbanes-Oxley Act, audit committees must be composed exclusively of independent directors.ⁿ³

Boards of directors often form so-called special committees to address transactions in which certain directors have a conflict of interest, such as management buy-outs or transactions involving a controlling stockholder.ⁿ⁴ Boards of directors also frequently use special committees to investigate allegations of wrongdoing and determine whether to initiate litigation on behalf of the corporation or permit a stockholder derivative suit to proceed.ⁿ⁵

Delaware law does not place significant restrictions or requirements on the ability of a board of directors to form and delegate authority to a committee. Under Section 141(c) of the Delaware General Corporation Law, the board of directors of a Delaware corporation has the power to "designate one or more committees, each committee to consist of one or more of the directors of the corporation."ⁿ⁶ The board may, with certain exceptions, delegate to a committee all of its power and authority of the board in managing the business and affairs of the corporation. The exceptions to the board's authority in this area depend on whether the corporation is governed by Section 141(c)(1) or (c)(2) of the Delaware General Corporation Law.

Section 141(c)(1) of the Delaware General Corporation Law governs all corporations incorporated prior to July 1, 1996 unless a majority of the whole board of such a corporation adopts a resolution declaring that the corporation shall be

governed by Section 141(c)(2).ⁿ⁷ Under Section 141(c)(1), a board committee may be granted the full powers of the board except that a committee may not be given the power to (i) amend the corporation's by-laws or certificate of incorporation, (ii) recommend to stockholders an amendment to the by-laws or certificate of incorporation, (iii) adopt an agreement of a merger or consolidation, (iv) recommend to the stockholders a sale of all or substantially all of the corporation's assets, or (v) recommend the corporation's dissolution or a revocation of a dissolution.ⁿ⁸ Also under Section 141(c)(1), a committee of the board may not declare a dividend, issue stock fixing the designations and any preferences or rights of certain classes of stock insofar as they relate to dividends, redemption, dissolution, any distribution of assets of the corporation or the conversion into, or the exchange of such shares for, shares of any other stock of the corporation, or approve a certificate of ownership in a short-form merger of a 90-percent-owned subsidiaryⁿ⁹ unless the resolution creating the committee, the by-laws, or the certificate of incorporation specifically bestows such powers upon the committee.ⁿ¹⁰

Section 141(c)(2) of the Delaware General Corporation Law governs all corporations incorporated on or after July 1, 1996.ⁿ¹¹ Section 141(c)(2) permits broader authority to be granted to board committees. Under Section 141(c)(2), any board committee "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation" to the extent granted in the by-laws or the resolutions creating the committee.ⁿ¹² There are two significant exceptions. First, a committee cannot approve, adopt, or recommend to shareholders any action or matter expressly required by the Delaware General Corporation Law to be submitted to shareholders for a vote.ⁿ¹³ Second, a committee cannot adopt, amend, or repeal any by-law.ⁿ¹⁴

The more limited powers and authorities that can be granted to a committee under Section 141(c)(1) require particular care when using a committee to issue blank check preferred stock.ⁿ¹⁵ Under Section 141(c)(1), a committee of the board of directors may, to the extent authorized in the resolutions providing for the committee, fix the designations of shares of blank check preferred stock, the number of shares in a series of such stock, and certain preferences or rights of such shares, *but not voting rights*, which must be established by the full board.ⁿ¹⁶ In contrast, committees governed by Section 141(c)(2) can fix the voting rights of blank check preferred stock so long as the resolution establishing the committee empowers the committee to do so.ⁿ¹⁷

Sections 141(c)(1) and (2) specifically provide for the designation of alternate members of committees. These sections permit the board to designate in advance the alternate members to replace an absent or disqualified member. Alternatively, the by-laws may set forth a procedure whereby the remaining committee members present at the meeting unanimously appoint an alternate.ⁿ¹⁸

In addition to committees of the board, the board may create any number of committees of the corporation. Committees of the corporation may only advise the board and do not have the power to act for the board. Because their role is advisory, committees of the corporation need not be created by the statutory procedure set forth in Section 141(c) and may have members other than current directors.ⁿ¹⁹

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretionBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityLimitationsBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral Overview

FOOTNOTES:

(n1)Footnote 1. See ABA Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 35 *Bus. Law.* 1335 (Apr. 1980); William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* §

1.04 (7th ed. 2003); E. Norman Veasey, *Standard of Care for Board Committees*, *The Corporate Director* (Mar.-Apr. 1981).

(n2)Footnote 2. ABA Committee on Corporate Laws, *Corporate Director's Guidebook*, 33 *Bus. Law* 1591 (1978); ABA Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 35 *Bus. Law* 1335 (Apr. 1980).

(n3)Footnote 3. Sarbanes-Oxley Act § 301. The audit committee is discussed in detail in Chapter 9 *below*.

(n4)Footnote 4. *See generally Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (Del. 1994) ; *Cohan v. Loucks*, CA 12323, 1993 *Del. Ch. LEXIS 99* (June 11, 1993) .

(n5)Footnote 5. *See, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 785 (Del. 1981) (reasoning that "an independent committee [of the board] possesses the corporate power to seek termination of a derivative suit. Section 141(c) allows a board to delegate all of its power to a committee"); *see also Perlegos v. Amtel Corp.*, 2007 WL 475453 (Del. Ch. Feb. 8, 2007) (upholding authority of special committee to remove officer, but not to cancel special shareholder meeting); Special committees of the board are discussed in detail in Chapter 11 *below*.

(n6)Footnote 6. *Del. Code Ann. tit. 8, § 141(c)* (2003).

(n7)Footnote 7. *Del. Code Ann. tit. 8, § 141(c)(1)* (2003).

(n8)Footnote 8. *Del. Code Ann. tit. 8, § 141(c)(1)* (2003).

(n9)Footnote 9. *See Del. Code Ann. tit. 8, § 253* (2003).

(n10)Footnote 10. *Del. Code Ann. tit. 8, § 141(c)(1)* (2003).

(n11)Footnote 11. *Del. Code Ann. tit. 8, § 141(c)(1)* (2003).

(n12)Footnote 12. *Del. Code Ann. tit. 8, § 141(c)(2)* (2003).

(n13)Footnote 13. *Del. Code Ann. tit. 8, § 141(c)(2)(i)* (2003).

(n14)Footnote 14. *Del. Code Ann. tit. 8, § 141(c)(2)(ii)* (2003).

(n15)Footnote 15. Blank check preferred stock has rights and preferences that are not specifically described in the certificate of incorporation, as allowed by *Del. Code Ann. tit. 8, § 151(g)*.

(n16)Footnote 16. *See* the 1985 Amendment to Section 141(c) and Commentary thereto.

(n17)Footnote 17. *Del. Code Ann. tit. 8, § 141(c)(2)* (2003).

(n18)Footnote 18. "The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, whether or not the member or members present constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member." *Del. Code Ann. tit. 8, § 141(c)(1) and (2)* (2003).

(n19)Footnote 19. *See Scattered Corp. v. Chicago Stock Exch.*, CA 14010, 1996 *Del. Ch. LEXIS 79*, *aff'd*, 701 A.2d 70 (Del. 1997) .



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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.03

AUTHOR: J. Travis Laster

§ 4.03 Basic Duties of Directors

[1] Overview of Directors' Duties

Under Delaware law, directors owe basic fiduciary duties of care and loyalty, along with the subsidiary duty of good faith.ⁿ¹ In addition to the traditional fiduciary duties, Delaware directors also have a duty of oversight. The duty of care generally requires directors to inform themselves of all material facts regarding a decision and to give the matter before them due deliberation before taking action. The duty of loyalty generally requires that directors act solely in furtherance of the best interests of the corporation and its shareholders. The duty of good faith is part of the duty of loyalty and requires that a director not intentionally or recklessly disregard his duties. The duty of oversight is a process-oriented duty that requires directors to act in good faith to establish an adequate system to monitor corporate compliance with legal obligations.

[2] The Duty of Care

The essence of the duty of care is the directors' obligation to inform themselves "prior to making a business decision, of all material information reasonably available to them."ⁿ² Directors should have sufficient opportunity to acquire knowledge material to the decisions they need to make and should have the benefit of the appropriate advice and input from management and advisers.ⁿ³ While the board must be reasonably informed, it need not be informed of every fact.ⁿ⁴ The duty of care becomes even more important in the context of a decision to sell the corporation or to engage in an extraordinary transaction.ⁿ⁵

Under Section 141(e) of the Delaware General Corporation Law, any member of the board of directors "shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."ⁿ⁶ Still, directors are only "entitled to good faith, not blind, reliance" on the reports of experts.ⁿ⁷ In fulfilling their duty of care, directors must make a "reasonable inquiry" into reports submitted to the board.ⁿ⁸

Section 141(e) will not preserve deferential business judgment review of a transaction approved by a board if the directors were deliberately misled by management or their advisors.ⁿ⁹ The Court of Chancery has held that a board of directors could not have reasonably relied on a valuation report that expressly disclosed that it was based on unverified and undocumented information (that allegedly consisted of fabrications by certain board members) and that relied on facts that the directors knew or should have known to be false.ⁿ¹⁰

In the post-trial decision in *In re The Walt Disney Co. Derivative Litigation*, the Court of Chancery held that a compensation committee reasonably relied on a compensation expert who worked with two members of the committee in analyzing a proposed compensation package for incoming company president Michael Ovitz.ⁿ¹¹ Upon publicity of Ovitz's severance payments upon his termination, the expert had made comments in the media criticizing his own failure to make certain calculations regarding the cost of potential termination payments. The Court, however, observed that it could not conclude that any member of the committee had actual knowledge that the expert's analysis was inaccurate or incomplete. The Court also held it unnecessary for the expert's advice or reports to be formally relayed to the committee as a whole for reliance to be proper under Section 141(e).ⁿ¹² Moreover, the Court held that directors may place good faith reliance on experts even when they do not follow that expert's recommendations to the letter. The Court noted that "[t]he role of experts under § 141(e) is to assist the board's decisionmaking--not supplant it," and that a contrary interpretation would conflict with the mandate of Section 141(a) that the corporation be managed "by or under the direction of a board of directors."ⁿ¹³

In reviewing directors' compliance with the duty of care, Delaware courts consider a number of factors, including whether the directors (i) had sufficient advance notification of the purpose of the meeting and documentation describing the essentials of any proposed course of action; (ii) were informed of pertinent internal and/or external developments leading to the issue under consideration; (iii) discussed the issue thoroughly and/or consulted with the appropriate independent legal, financial, or other advisors; (iv) reviewed or received presentations on the relevant documents or summaries or extracts of the documents; (v) made reasonable inquiries into and critiqued the proposed course of action; and (vi) took sufficient time under the circumstances and acted in a deliberative manner. While directors should not act with undue haste, they may act speedily when necessary or appropriate. Directors must understand the transaction proposed and they must take adequate time to reflect. The directors' duty of care also requires them to comply with established principles of Delaware law.ⁿ¹⁴

[3] The Duty of Loyalty

The essence of the duty of loyalty is that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests [A]n undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."ⁿ¹⁵ The Court of Chancery has explained,

[I]t is possible to say broadly that the duty of loyalty is transgressed when a ... director ... uses his or her corporate office ... to promote, advance or effectuate a transaction between the corporation and such person (or an entity in which the fiduciary has a substantial economical interest, directly or indirectly) and that transaction is not substantively fair to the corporation. That is, breach of loyalty cases inevitably involve conflicting economic or other interests, even if only in the somewhat diluted form present in every "entrenchment case."ⁿ¹⁶

Analysis of the duty of loyalty typically turns on two concepts: independence and interest. A director is deemed to be independent "when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences."ⁿ¹⁷ A director is considered "interested" when divided loyalties are present, or when, as a result of a transaction, the director enjoys a special benefit that is not available to all the corporation's shareholders.ⁿ¹⁸ The alleged conflict of interest must be actual and imminent, and not speculative and remote.ⁿ¹⁹

Divided loyalties exist when a director serves on the boards of two corporations where each has a stake in the proposed

transaction.ⁿ²⁰

A personal interest in a transaction exists when the director stands to receive a benefit from the transaction that is material in the context of that specific director's personal circumstances such that the interest affects or is likely to affect the director's actions.ⁿ²¹ The interest may arise indirectly, such as through benefits conferred on a family member.ⁿ²² A director's receipt of customary director fees, standing alone, is not a disqualifying financial interest.ⁿ²³ The receipt of indemnification for litigation expenses likewise does not taint directors with a presumption of self-interest.ⁿ²⁴

In analyzing duty of loyalty issues, it is important to remember that directors of a Delaware corporation owe fiduciary duties to all of the corporation's shareholders and not just to the holders of the particular class or series of stock that may have elected them.ⁿ²⁵ If a decision poses a conflict between two different classes of shareholders (one of which may have elected some or all of the directors), directors should be acutely aware of and sensitive to any conflicting interests. In those circumstances, it may be the case that "total abstinence from attendance and participation in the discussion is appropriate."ⁿ²⁶

Preferred stock presents slightly different issues. Directors generally owe fiduciary obligations to holders of preferred stock.ⁿ²⁷ But when the holders of the preferred stock invoke their preferences or other contractual rights, the directors' fiduciary duties do not apply and the corporation's obligations are determined by the language of the preferred stock designations and principles of contract law.ⁿ²⁸

While directors owe fiduciary duties to the corporation and its shareholders, a board of directors may, under certain circumstances, take other constituencies into account. Among such constituencies are "creditors, customers, employees, and perhaps even the community generally."ⁿ²⁹ For example, when a corporation is in the vicinity of insolvency and "where foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock ... an independent board may consider the impacts upon all corporate constituencies in exercising its good faith business judgment for [the] benefit of the 'corporation.'"ⁿ³⁰ Similarly, when responding to a threatened takeover, directors may properly consider "the impact [of the bid] on constituencies other than shareholders."ⁿ³¹ Consideration of other constituencies, however, should always be in the context of how benefiting those constituencies ultimately benefits shareholders.ⁿ³² If there is no long-term plan for the corporation in which benefits for other constituencies would benefit shareholders, then the board of directors no longer has a basis for considering other constituencies. For example, as the Delaware Supreme Court has explained, "concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder."ⁿ³³

There is limited support under Delaware law for the concept of an unintentional breach of the duty of loyalty.ⁿ³⁴ These instances have occurred primarily in the context of defensive responses to hostile takeovers. In *Blasius Industries, Inc. v. Atlas Corp.*, for example, the court affirmatively found that the directors of Atlas corporation acted in good faith but had nonetheless breached their fiduciary duty of loyalty.ⁿ³⁵ The court accepted the directors' explanation that they had added two members to the company's board of directors as a well-intentioned response to a stockholder's proposed recapitalization plan. Nevertheless, the court found that the directors' actions, however, were "designed principally to interfere with the effectiveness of a [stockholder] vote" and were therefore invalid.ⁿ³⁶ The court explained "that the concept of an unintended breach of the duty of loyalty is unusual but not novel."ⁿ³⁷

[4] The Duty of Good Faith As Part Of The Duty Of Loyalty

The Court of Chancery decision in *Disney* provided significant insight into the contours of good faith under Delaware law.ⁿ³⁸ The court observed that it was likely easier to define bad faith, which would include "authorizing a transaction for some purpose other than a genuine attempt to advance corporate welfare or [when the transaction] is known to constitute a violation of applicable positive law."ⁿ³⁹ It does not matter why the director intentionally fails to pursue the best interests of the corporation. Bad faith can be the result of anything that causes a director to "intentionally place his

own interests, preferences or appetites before the welfare of the corporation, including greed, hatred, lust, envy, revenge, shame, or pride."⁴⁰ The Court of Chancery concluded that:

intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.⁴¹

The Delaware Supreme Court affirmed the Court of Chancery's decision in *Disney* and adopted the trial court's view of good faith.⁴² The court explained that one type of good faith violation is predicated on intentional misconduct.⁴³ The second type of good faith violation, it continued, is based on the Court of Chancery's formulation of an "intentional dereliction of duty" or "a conscious disregard for one's responsibilities."⁴⁴ The court held, however, that this latter category requires a showing of culpability beyond gross negligence: "Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith."⁴⁵

In *Stone v. Ritter*, the Delaware Supreme Court held that the duty of good faith is not a standalone fiduciary duty, but instead is a subpart of the broader duty of loyalty.⁴⁶ Thus, director liability can be established only by showing a care or loyalty violation, with good faith operating as part of the duty of loyalty. This holding provides some doctrinal clarity in corporate law and makes clear that there is no "triad" of fiduciary duties. The practical implications of the opinion, however, are limited. Corporate fiduciaries should be advised that they are subject to the duties of care and loyalty. The duty of loyalty includes the traditional prohibition against self-dealing and governs conflicts of interest, but it also encompasses the obligation to act in good faith.

Recent cases emphasized the "*mens rea*" aspect of the duty of good faith. In *Lyondell Chemical Company v. Ryan*,⁴⁷ the Delaware Supreme Court reversed a chancery court ruling where the trial court erroneously "equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith." The chancery court has interrelated the duty of good faith as requiring facts from which intentional conduct can be inferred, such that reckless conduct is not sufficient to give rise to a finding of bad faith.⁴⁸ Detailed allegations that directors and officers engaged in knowing violations of criminal law was held sufficient to state a claim for action in bad faith.⁴⁹ Another area in which director action was framed as a violation of the subsidiary duty of good faith was in the backdating or "spring loading" of stock options. In *Ryan v. Gifford*, the Court of Chancery concluded that directors "should not be surprised to find that lying to shareholders [by backdating options] is inconsistent with loyalty, which necessarily requires good faith."⁵⁰

[5] The Duty of Oversight

The fiduciary duty of care is not limited to making decisions. Directors also have a duty to exercise care in overseeing the business and operations of the corporation and the conduct of corporate employees. In *Graham v. Allis-Chalmers*, the Delaware Supreme Court held that

[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.⁵¹

Revisiting the issue 36 years later in *In re Caremark International, Inc. Derivative Litigation*,⁵² the Delaware Court of Chancery elaborated on the nascent duty of oversight identified in *Graham* and held that directors have a

responsibility to assure that appropriate information and reporting systems are established and implemented so that senior management and the board have adequate information on the company's business and operations, material events, and compliance with applicable statutes and regulations. The court rejected an interpretation of *Graham* that would not impose a duty on directors (absent some basis to suspect a legal violation) to assure that a corporate information gathering and reporting system exists to provide senior management and the board of directors with information about the company's business and operations, material events, and compliance with applicable statutes and regulations.

Then-Chancellor William T. Allen's opinion in *Caremark* marked the beginning of a sea change in Delaware jurisprudence regarding the duty of oversight. Caremark International, Inc. ("Caremark") and some of its mid-level employees had been indicted for alleged violations of federal health-care reimbursement regulations. Thereafter, Caremark shareholders filed five derivative actions in the Court of Chancery. The derivative actions alleged that Caremark's directors had breached their fiduciary duty of care by permitting the alleged violations to occur. The shareholders claimed that the directors had failed to monitor the company's employees or to institute corrective measures, thus exposing the company to significant liability. Caremark and its directors reached an agreement to settle the government investigations and the derivative litigation. As part of the settlement, Caremark agreed, among other things, to establish a new compliance and ethics committee of the board and a centralized system for regular monitoring of legal compliance at lower levels of management and in the field.

In the course of approving what would otherwise have been a routine settlement, Chancellor Allen took on the issue of whether the shareholder plaintiffs had the ability to hold directors liable for losses arising "from unconsidered inaction."⁵³ Chancellor Allen summarized the claim as one in which "the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."⁵⁴ Chancellor Allen described such a claim as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."⁵⁵ He agreed, however, that directors may be held liable under such a theory:

[I]t would ... be a mistake to conclude ... that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance [A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists [F]ailure to do so under some circumstances may ... render a director liable⁵⁶

Having outlined this theory of liability in broad strokes, Chancellor Allen then articulated four limiting principles. First, "only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability."⁵⁷ Second, "the level of detail that is appropriate for such an information system is a question of business judgment."⁵⁸ Third, since "no rationally designed information system will remove the possibility" of losses, the plaintiff must establish and the court must find that the failure of oversight was the "proximate cause" of the damage.⁵⁹ Fourth, a charter provision adopted pursuant to Section 102(b)(7) of the Delaware General Corporation Law might completely insulate covered directors from liability.⁶⁰ These limitations significantly restrict the risk of liability that otherwise might exist from a broad oversight obligation.

In applying the duty of oversight to the situation in *Caremark*, Chancellor Allen went further in restricting the doctrine by holding that the internal systems at Caremark appeared sufficient to render the complaint "susceptible to a motion to dismiss."⁶¹ At the time of the alleged wrongdoing, however, Caremark had only the most basic of controls in place: a generic internal audit program and the services of an outside auditor. Caremark did not take more significant action until after the crisis. The board asked its outside auditor to review and report on the company's internal audit system and

adopted a new and strengthened internal audit policy.⁶² The board also took steps to ensure that it was receiving regular reports from management by centralizing the management reporting structure and appointing a senior Caremark executive as a compliance officer.⁶³ Chancellor Allen's analysis thus suggests that a generic internal audit plan, an independent auditor, and perhaps corrective action after the fact may be sufficient to defeat a duty of oversight claim.

The Delaware Supreme Court has adopted the rationale of *Caremark* but has described the duty as one of good faith.⁶⁴ The undeniable lesson from *Stone* and *Caremark* is that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."⁶⁵ Failing to fulfill this duty could render a director liable.⁶⁶

In the post-Enron business environment, *Caremark* oversight has become even more significant. The actions of directors are increasingly viewed under an unfriendly microscope. In this environment, directors are demanding additional information and procedural protections to ensure that they have met their duty of oversight obligations. The *Caremark* duty also has been reinforced by the corporate governance listing requirements of the New York Stock Exchange, which assign to the board audit committee a duty to "assist board oversight of ... the company's compliance with legal and regulatory requirements."⁶⁷

To protect against duty of oversight claims, boards and/or their audit committees⁶⁸ are well advised to do the following:

- Have the chief legal officer and the chief compliance officer--or persons performing similar functions--periodically (perhaps annually or biennially) make a comprehensive presentation to the board or the audit committee on the company's compliance policies, systems, and procedures, including its code of conduct.
- Have the chief legal officer or other appropriate officer report to the board audit committee, or to the board as a whole, on
 - major regulatory issues and issues arising in civil litigation (or threatened civil litigation) that, in either case, implicate possible ethical violations, violations of the company code of conduct or of company policies relating to honesty, proper use of company assets, and the like; and
 - any proceeding, investigation, or other matter involving alleged or possible criminal conduct (whether under U.S. law or the law of any other jurisdiction) on the part of any officer or on the part of any employee in the course of the performance of his or her duties as an employee.
- In either case,
 - require the responsible corporate officer to report on what the company has done or is doing to investigate and eliminate, or reduce the likelihood of, any breakdowns in compliance procedures that may have allowed such conduct to occur or to go undetected for any period of time, and follow up in subsequent meetings until all appropriate modifications in systems or procedures have been completed and documented to the satisfaction of the board or committee; and
 - inquire into and be satisfied with the disciplinary action taken against any officer or employee who has committed intentional wrongdoing or, in appropriate cases, should be put on administrative suspension and relieved of his or her duties pending the

investigation of alleged wrongdoing.

- Receive a regular report on any complaints or allegations that the company has received on its "hotline" (even if the communication was not directed to the outside directors per se) alleging fraud or other intentional wrongdoing.
- Have a regularly scheduled executive session with the chief legal officer, without the presence of other corporate officers.

Directors may also take care to document compliance with Chancellor Allen's limiting principles. For instance, directors may wish to document with specificity the manner in which they have attempted to assure that a reasonable information and reporting system exists. Directors may also seek the advice of expert consultants in information management to advise them on an appropriate system for their particular corporation. Such a step would, of course, be documented and might serve to defeat causation thus preventing recovery.

[6] Business Judgment Rule

Out of respect for the board of directors' statutory and fiduciary duty and obligation to manage and oversee the business and affairs of a corporation, courts have developed a policy of affording substantial deference to the business decisions that disinterested and independent corporate directors have made in good faith and after due deliberation. This policy is referred to as the "business judgment rule," and when it applies, the decisions of a board of directors "will not be disturbed if they can be attributed to any rational business purpose."⁶⁹ "A court under such circumstances will not substitute its own notions of what is or is not sound business judgment."⁷⁰

The business judgment rule is the product of multiple factors, including (i) Section 141(a) of the Delaware General Corporation Law, which provides that the "business and affairs" of the corporation "shall be managed by or under the direction of a board of directors";⁷¹ (ii) recognition that courts are ill-equipped in terms of substantive knowledge to engage in meaningful review of "ordinary" business decisions;⁷² (iii) the need to encourage entrepreneurial risk taking; and (iv) the fact that a corporation will only be able to recruit competent directors if their potential liability for erroneous decisions is limited.⁷³

Ordinarily, the effect of reviewing a transaction pursuant to the business judgment rule is to preclude director liability unless the plaintiff can show a breach of fiduciary duty.⁷⁴ The prerequisites for the application of the business judgment rule were set forth by the Delaware Supreme Court in *Aronson v. Lewis*:⁷⁵

First, "the business judgment rule operates only in the context of director action [or conscious inaction]. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."⁷⁶

Second, the rule's "protections can only be claimed by disinterested [and independent] directors."⁷⁷

Third, "[t]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."⁷⁸

Fourth, the business judgment rule applies only where directors acted "in good faith and in the honest belief that the action taken was in the best interests of the company."⁷⁹

[a] Presumption of Regularity

While the presumption of regularity is strong in the context of ordinary business decisions, its strength varies according to the context in which the business judgment rule is raised.ⁿ⁸⁰ In some circumstances, directors are not entitled to the benefit of the business judgment presumption until they make a threshold showing. For example, when the justification of a particular defensive measure is at issue, the business judgment rule will not apply until the board meets an initial burden of showing that it acted with good faith after a reasonable investigation and adopted a defensive measure that was reasonable in relation to the threat posed.ⁿ⁸¹ The presumption is weaker in such settings because of the inherent conflict directors face when deciding how to respond to a threat to their control of the corporation.ⁿ⁸² But even in such circumstances, the deference paid to directors' decisions is "heightened" or "materially enhanced" where a majority of the members of the subject board are independent, outside directors.ⁿ⁸³

[b] Rebutting the Presumption

Because directors are presumed not to breach their duties of care and loyalty, the business judgment rule has the effect of precluding a court from re-examining the merits of a board's decision, unless the plaintiff is able to plead facts rebutting one of the elements of the rule. When a plaintiff can point to facts calling into question the applicability of the presumption, a court will engage in "a threshold review of the objective financial interests of the board whose decision is under attack (that is, independence), a review of the board's subjective motivation (that is, good faith), and an objective review of the process by which it reached the decision under review (that is, due care)."ⁿ⁸⁴

As mentioned above, the party challenging director action bears the burden of rebutting the business judgment presumption by showing that board members acted disloyally or without due care. The most frequently invoked method of attacking the presumption is to claim a breach of the duty of loyalty due to director interest in the challenged transaction.ⁿ⁸⁵ Delaware courts have "refrained from adopting a bright-line rule for determining when a director's ... self-interest translates into evidence sufficient to rebut the business judgment" rule.ⁿ⁸⁶

The business judgment rule can also be rebutted by evidence of directors' gross negligence in the decision making process.ⁿ⁸⁷ As opposed to the "reasonably prudent person" standard for simple tort law negligence, "gross negligence" in the duty of care context requires a showing that directors "acted without the bounds of reason and recklessly" in making their decision.ⁿ⁸⁸ The very few cases that have held that this high standard for liability was met have involved boards who had not attempted to gather or consider helpful or relevant information to aid them in making important decisions.ⁿ⁸⁹ The cases also typically involve boards that have acted with needless haste.ⁿ⁹⁰

[c] Legal Consequences of Finding that a Board Acted Within Its Business Judgment

When a party challenging board action is able to rebut an element of the business judgment rule, then the directors may be personally liable for any damages resulting from their breach of fiduciary duty unless their actions are shown to be entirely fair to the corporation and its stockholders. Section 102(b)(7) permits a corporation to exculpate directors from liability for breaches of the duty of care, but not for breaches of the duty of loyalty.ⁿ⁹¹ A Section 102(b)(7) provision will not prevent a transaction from being enjoined or rescinded by a reviewing court.ⁿ⁹²

When a party challenging board action is unable to rebut the business judgment presumption, the directors will not be held personally liable, even when hindsight demonstrates that their decision was ill-advised or incorrect.ⁿ⁹³ The business judgment rule will similarly protect a corporate transaction against rescission or injunction, regardless of whether it might reasonably be thought harmful to the corporation or its stockholders.ⁿ⁹⁴ Under business judgment review, a court simply will not reach the merits of the challenged decision.ⁿ⁹⁵

There are certain frequently encountered descriptions of the business judgment rule that suggest that, even if the plaintiff fails to rebut the business judgment presumption, extreme circumstances may warrant a court substituting its own judgment for that of the disinterested directors. As former Chancellor Allen once noted, "[t]his 'escape hatch' language has been variously stated in the Delaware opinions: 'egregious' decisions are said to be beyond the protections

of the business judgment rule, as are decisions that cannot 'be attributed to any rational business purpose,' or decisions that constitute 'a gross abuse of discretion.'ⁿ⁹⁶ Though such terms appear frequently as *dicta* in cases upholding directors' decisions, the relatively few cases that ascribe them substantive content suggest that they add nothing to the well-established notions that directors cannot waste corporate assets or otherwise act in bad faith.

The sole Delaware decision that may be construed as granting relief from a board decision that lacked a rational business purpose is *Gimbel v. Signal Cos., Inc.*ⁿ⁹⁷ In *Gimbel*, the Delaware Supreme Court preliminarily enjoined a corporate parent from selling its subsidiary for an allegedly "wholly inadequate" sale price.ⁿ⁹⁸ The *Gimbel* court noted that board decisions "will not be disturbed if they can be attributed to any rational business purpose," citing *dictum* from a prior Delaware Supreme Court case.ⁿ⁹⁹ The *Gimbel* court then framed the actual legal issue for decision as follows: "Did the Signal Directors act recklessly in accepting a wholly inadequate price for Signal Oil?"ⁿ¹⁰⁰ Director recklessness generally suggests gross negligence in the decision-making process, which is itself sufficient to rebut the presumption that directors acted with due care.ⁿ¹⁰¹ Alternatively, director recklessness suggests a bad faith indifference to the corporate welfare, which also suffices to rebut the business judgment presumption.ⁿ¹⁰² The *Gimbel* court's analysis focused on director carelessness due to needless haste, finding that a "forced decision" to sell the subsidiary was made "on a tight time schedule."ⁿ¹⁰³ The court also focused on the possibility that the sale would entail a waste of corporate assets, given that the plaintiff claimed the subsidiary was worth almost twice as much (and several hundred million dollars more) than the defendant claimed.ⁿ¹⁰⁴ The *Gimbel* decision thus need not be viewed as depending on the lack of a "rational basis" for the directors' decision. Interestingly, although the court preliminarily enjoined the sale of assets, the injunction issued contingent upon the plaintiffs' posting of a substantial bond. As former Chancellor Allen later observed, "the obviously problematic nature of entering an injunction (even a preliminary injunction) against directors, while at the same time holding that they were neither suffering from any conflicting interest nor acting in bad faith, caused the *Gimbel* court to impose a bond that was unprecedented in size, especially for the period (\$25 million) and which, in fact, was never satisfied. Therefore, while the court indicated its conditional willingness in *Gimbel* to enter an injunction, in fact no relief ever issued."ⁿ¹⁰⁵

Along similar lines, several Delaware cases in the derivative suit context have found that pre-suit demand upon a board of directors would be futile because, although the board was disinterested and independent, there was a "reasonable doubt" that the transaction challenged was "otherwise the product of a valid exercise of business judgment."ⁿ¹⁰⁶ At first blush these cases suggest that a reviewing court has free rein to pass upon the "soundness" or "egregiousness" of a board's decision.ⁿ¹⁰⁷ Yet the relatively few decisions excusing demand on this ground add nothing to the simple and well-established notion that a waste or gift of corporate assets will not be protected by the business judgment presumption.ⁿ¹⁰⁸

Finally, a similarly problematic description of the business judgment presumption suggests that, even where the presumption would normally apply to protect a board's decision, it may be rebutted by evidence showing "gross and palpable overreaching" by the board.ⁿ¹⁰⁹ The phrase "gross and palpable overreaching" first appeared in Delaware cases involving the business judgment rule in 1967, in the Delaware Supreme Court's opinion in *Meyerson v. El Paso Natural Gas Co.*ⁿ¹¹⁰ In refusing to reform an agreement between a parent and subsidiary corporation, the *Meyerson* court quoted from a dissenting opinion from the New York Court of Appeals, which emphasized on similar facts that "anything short of gross and palpable overreaching does not warrant court interference."ⁿ¹¹¹ The phrase quickly became a part of the recitation of the business judgment rule in parent-subsidiary transactions.ⁿ¹¹² Yet the statement that the business judgment rule does not embrace "gross and palpable overreaching" merely underscores that the business judgment presumption only applies to actions taken by disinterested fiduciaries, in good faith, in the honest belief that such action is in the best interests of the corporation.ⁿ¹¹³ Indeed, no Delaware decision has actually found the business judgment presumption to be rebutted by "gross and palpable overreaching," as opposed to other forms of disloyal and self-dealing conduct. Yet the repetition of unnecessary rhetoric tends to create confusion in the law.ⁿ¹¹⁴

[d] Implications for Board Processes and Procedures

Given the powerful effect of the business judgment rule, directors should seek to craft board processes and procedures that increase the likelihood that their decisions will benefit from the rule. As a general matter, the board should be informed, diligent and act in an independent and disinterested manner. The post-trial decision in the *Disney* matter,ⁿ¹¹⁵ "strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken."ⁿ¹¹⁶ While the Court in *Disney* also noted that Delaware law will not hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices alone, compliance with such best practices where appropriate will help serve to demonstrate the board's faithfulness and honesty on behalf of the stockholders.

Adherence to the following guidelines will maximize the chances that a board's decision will be protected by the business judgment rule, rather than be subject to second guessing by plaintiffs and judges:

- A good set of written materials should be delivered to each director in time to allow him or her to review them carefully in advance of the meeting. These may include memoranda from the CEO or other executives responsible for the proposed transaction to be decided upon, copies of agreements and resolutions the board will be asked to approve, investment bankers' financial analyses, and lawyers' summaries of the major and most important legal issues or contract provisions involved in the decision the board will be asked to make. The larger the packet and the more complex the materials, the more time should be allowed for the directors to read and digest them before the meeting.

- In the event that the board packet includes lengthy agreements (such as a long merger agreement or loan agreement) or other legal documents, the most important provisions should be separately and clearly explained to the directors. This can be done in a "bullet point" executive summary that goes out with the board packets or by a live presentation at the board meeting to "walk the directors through" the most important aspects of the documents and the transaction they are being asked to consider.

- The board should be sure that it has access to all the information it needs to evaluate the proposed transaction and its alternatives. While an investment banker's fairness opinion is not required as a matter of law, it is good practice for the directors to have the benefit of such an opinion and to make sure that they understand the basis for it before approving any major merger, acquisition, or disposition of material assets.

- It should be clear that the board, or any committee of the board, is free to retain independent experts at the company's expense when necessary and appropriate. In connection with major issues involving executive compensation, it can be useful for the outside directors to hear from independent executive compensation consultants that they, rather than the executives, have retained. In connection with any issue involving the propriety of actions taken by management, the directors should consider whether they would benefit from the input and assistance of independent counsel with no regular or ongoing business relationship with the company.

- While the independent directors are not required to meet separately in executive session in connection with every decision the board is asked to make, they should consider doing so whenever executive directors may have interests that differ from those of the shareholders (such as when they will receive significant compensation or severance in connection with the proposed transaction).

- The board should allow plenty of time for consideration and discussion of the proposed transaction, over the course of more than one meeting if appropriate and time permits. Boards should not hesitate to act quickly when a business opportunity may be fleeting, but decision-making should never be rushed when there is not a compelling reason for a prompt decision.

- Directors should not vote on any transaction until they are satisfied with the answers to these

questions:

- How much will it cost?
- What is the benefit to the company and its shareholders?
- What are the alternatives? Had management explored them to the point of reasonable assurance that this is the best course of action available?

■ Minutes of meetings should be reasonably detailed and promptly drafted for approval by the board.¹⁷

In addition to these guidelines, the former Chief Justice of the Delaware Supreme Court has suggested a list of "aspirational norms" of board practice:

- (1) [T]here should be a heavy majority of purely independent directors on every board.
- (2) The board should be engaged in actual governance, and not merely act as advisors to the Chief Executive Officer. This does not mean that the board runs the operations of the company (normally they should not). It means directors are in control of the policy of the firm and the managers work for them.
- (3) The directors should meet face-to-face frequently throughout the year and spend substantial time on their homework. A norm of at least one hundred hours per year on each board has been suggested and seems reasonable Of course more than the norm may be required in time of crisis, and directors should not become so over-committed that they cannot deal adequately with crises.
- (4) The directors should limit to a reasonable number the major boards on which they serve. What is a reasonable number depends on the extent to which each director is able to carry out his or her responsibilities to each board in a professional manner.
- (5) Independent directors should regularly evaluate the CEO and they should meet with each other alone in executive session on a regular basis. The board should have independent audit compensation and nominating committees. In most instances at least the audit and compensation committees should be independently advised.
- (6) The board should establish and monitor reasonable law compliance programs.
- (7) The board should carefully review disclosure documents to ensure that all material information reasonably available is disclosed to the relevant audience.¹⁸

Adherence to these "aspirational norms" does not guarantee that a particular business decision will receive the benefit of the business judgment rule. Rather, each factual circumstance is unique and must be evaluated in context. Thus, there is no exact formula or routine that will provide protection in all circumstances. Nevertheless, a board that adopts processes and procedures designed to increase the likelihood that a particular decision will be protected by the business judgment rule should find itself in an advantageous position if the decision is challenged, both from the standpoint of their potential exposure for personal liability and from the standpoint of the potential for their decision to be restrained or enjoined.¹⁹

The *Disney* post-trial decision also offers several lessons to be learned regarding board independence. While the Court of Chancery there found that the defendants had acted in good faith and therefore entered judgment in favor of all

defendants, it was at times sharply critical of defendants' actions:

- The Court criticized CEO and Chairman Michael Eisner for being "imperial" and for unduly handling the Board.ⁿ¹²⁰
- The Court criticized the Board in strident terms for not exhibiting more assertiveness and independence.ⁿ¹²¹
- The Court criticized minutes of meetings for not being informative enough regarding what topics had been discussed and, in particular, whether certain topics were discussed for a much longer span of time than other topics.ⁿ¹²²
- The Court criticized Eisner for acting in a unilateral manner by not calling a board meeting prior to sending out a press release announcing the hiring of President Michael Ovitz.ⁿ¹²³
- The Court said that it would have been ideal for certain compensation committee members to have been better qualified and more involved in the decision regarding an appropriate compensation package for Ovitz.ⁿ¹²⁴
- The Court criticized the board for not meeting to discuss Ovitz's non-fault termination which, under his contract, entitled Ovitz to certain non-fault termination payments, while holding that it had no duty to do so.ⁿ¹²⁵
- The Court criticized a press release which stated that Ovitz would continue to serve as an advisor and consultant to the board subsequent to his termination when in fact such an arrangement had been rejected.ⁿ¹²⁶

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses Business Judgment Rule Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Care Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Good Faith Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Loyalty

FOOTNOTES:

(n1)Footnote 1. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) .

(n2)Footnote 2. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1983)) .

(n3)Footnote 3. See *Moran v. Household Int'l. Inc.*, 490 A.2d 1059, 1075 (Del. Ch. 1985) , *aff'd*, 500 A.2d 1346 (Del. 1985) . See also William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors*, Ch. 3 (7th ed. 2003).

(n4)Footnote 4. See *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998) , *aff'd in part, rev'd in part on other grounds sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ; See also *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, C.A. No. 4446, 2009 WL 1337150 (Del. Ch. May 12, 2009) (.observing that although "no one suggests that the directors' duty of care required them to review, discuss and comprehend every

word of the 98-page Indenture," that "terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board. In this way, the board will be able to exercise its fully informed business judgment").

(n5)Footnote 5. See *Paramount Communications v. QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994) ("this Court has stressed the importance of being informed in negotiating a sale of control").

(n6)Footnote 6. *Del. Code Ann. tit. 8, § 141(e)* (2003).

(n7)Footnote 7. *Smith v. Van Gorkom*, 488 A.2d 858, 875, 880 (Del. 1985) ; see *Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732 (Del. Ch. 2007) (rejecting Section 141(e) defense).

(n8)Footnote 8. *Van Gorkom*, 488 A.2d 858 .

(n9)Footnote 9. See *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1283-1284 (Del. 1988) .

(n10)Footnote 10. See *California Pub. Employees' Ret. Sys., Inc. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144, at *46 (Dec. 18, 2002) (explaining, "[S]uch knowledge would seem to be more readily accessible than it was avoidable among a group of individuals who had shared long years of an assortment of business and personal relationships [I]t is hard to see how the special committee could have in good faith accepted earnings projections in excess of historical performance, particularly with no explanation or documentation provided either to the committee or to the investment bankers [making the report]").

(n11)Footnote 11. *In re The Walt Disney Co. Deriv. Litig.*, 2005 Del. Ch. LEXIS 113, at *221 (Aug. 9, 2005), *aff'd*, 906 A.2d 27 (Del. 2006) .

(n12)Footnote 12. *Disney*, 2005 Del. Ch. LEXIS 113, at *118-221 .

(n13)Footnote 13. *Disney*, 2005 Del. Ch. LEXIS 113, at *221 n.550 .

(n14)Footnote 14. See *Metropolitan Life Ins. Co. v. Aramark Corp.*, CAs 16142, 16170, 16171, 1998 Del. Ch. LEXIS 70, at *1 (Feb. 5, 1998) (transcript ruling) (preliminarily enjoining a recapitalization transaction which included an impermissible private company discount).

(n15)Footnote 15. *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) .

(n16)Footnote 16. *Solash v. Telex Corp.*, CAs 9518, 9528, 9525, 1988 Del. Ch. LEXIS 7, at *19 (Jan. 19, 1988) .

(n17)Footnote 17. *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985) .

(n18)Footnote 18. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1988) .

(n19)Footnote 19. See *Smith v. Good Music Station, Inc.*, 129 A.2d 242, 247 (Del. Ch. 1957) . See also William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors*, Ch. 4 (7th ed. 2003).

(n20)Footnote 20. See, e.g., *Kennedy v. Emerald Coal & Coke Co.*, 28 Del. Ch. 405, 42 A.2d 398, 402 (Del. 1944) , *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) . "In such circumstances, the 'interest' is created by the conflicting duties of loyalty owed by him to each corporation." 1 David A. Drexler *et al.*, *Delaware Corporation Law and Practice* § 15.05[1] (LexisNexis Matthew Bender).

(n21)Footnote 21. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1169 (Del. 1995) .

(n22)Footnote 22. See *California Pub. Employees' Ret. Sys., Inc. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144

, at **28-29 (Dec. 18, 2002) (finding that director's strong personal and professional relationship with fellow director, as well as son's current employment in company owned by fellow director, created reasonable doubt of director's ability to exercise independent business judgment with respect to transactions between corporation and companies owned by fellow director).

(n23)Footnote 23. *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) .

(n24)Footnote 24. *Grover*, 642 A.2d 792, 804 (Del. Ch. 1993) , *aff'd*, 633 A.2d 371 (Del. 1993) (TABLE).

(n25)Footnote 25. See *Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 710 (Del. 1983) ("Signal designated directors on UOP's board still owed UOP and its shareholders an uncompromising duty of loyalty"); *Phillips v. Insituform of N. Am. Inc.*, CA 9173, 1987 Del. Ch. LEXIS 474, at *30 (Aug. 27, 1987) (the "law demands of directors ... fidelity to the corporation and all of its stockholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them").

(n26)Footnote 26. 1 R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Law of Corporations & Business Organizations*, § 4.11 (3d ed. 1999) (footnote omitted).

(n27)Footnote 27. See, e.g., *David J. Greene & Co. v. Schenley Indus. Inc.*, 281 A.2d 30 (Del. Ch. 1971) ; *Lewis v. Great W. United Corp.*, No. 5397, 1978 Del. Ch. LEXIS 723 (Mar. 28, 1978) .

(n28)Footnote 28. See *HB Korenvaes Inv., L.P. v. Marriott Corp.*, CA 12922, 1993 Del. Ch. LEXIS 90 (June 9, 1993) ; *Jedwab v. MGM Grand Hotels. Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986) ; see also *In re Appraisal of Metromedia Intern. Group, Inc.*, No. 3351, 2009 WL 1110663 (Del. Ch. April 16, 2009).

(n29)Footnote 29. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) .

(n30)Footnote 30. *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1058 n.2 (Del. Ch. 1997) . Although a board may consider these factors, Delaware law does not recognize a creditor's right to bring direct claims for breach of fiduciary duty against directors of a corporation that is insolvent or in the zone of insolvency. *N. Am. Catholic Educ. Prog'g Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007) .

(n31)Footnote 31. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341-1342 (Del. 1987) .

(n32)Footnote 32. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) .

(n33)Footnote 33. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) .

(n34)Footnote 34. *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906 (Del. Ch. 1980) ; *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) ; *State of Wisconsin Investment Board v. Peerless Systems Corp.*, 2000 WL 1805376 (Del. Ch. Dec. 4, 2000) .

(n35)Footnote 35. 564 A.2d 651, 663 (Del. Ch. 1988) .

(n36)Footnote 36. *Blasius Industries*, 564 A.2d at 660 .

(n37)Footnote 37. *Blasius Industries*, 564 A.2d at 663 (citing *Lerman*, 421 A.2d 906 ; *AC Acquisitions Corp.*, 519 A.2d 103). The Court of Chancery has since moved to reformulate the inquiry in *Blasius Mercier v. Inter-Tel*, 929 A.2d 786 (Del. Ch. 2007) . In *Mercier*, the court held that the initial burden in a *Blasius* lawsuit is on the directors to show proper negotiation and a legitimate corporate objective. To defend successfully, however, the directors must prove "that their actions were reasonable in relation to their legitimate objective, and did not preclude the stockholders from exercising their right to vote or coerce them into voting a particular way." *Id.* at 810 . The *Mercier* decision also notes that although courts should be "vigilant" in policing "the director election process," this test should not be applied unless

either corporate control or election of directors is at issue. *Id.* at 811 .

(n38)Footnote 38. *In re The Walt Disney Co. Deriv. Litig.*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) .

(n39)Footnote 39. *Disney*, 2005 Del. Ch. LEXIS 113, at *169-170 (internal quotation omitted).

(n40)Footnote 40. *Disney*, 2005 Del. Ch. LEXIS 113, at *173 (internal quotation omitted).

(n41)Footnote 41. *Disney*, 2005 Del. Ch. LEXIS 113, at *175 (internal citations omitted).

(n42)Footnote 42. *In re the Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006) .

(n43)Footnote 43. *See Walt Disney*, 906 A.2d at 64 .

(n44)Footnote 44. *Walt Disney*, 906 A.2d at 66.

(n45)Footnote 45. *Walt Disney*, 906 A.2d at 66.

(n46)Footnote 46. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (finding that "imposition of liability requires a showing that the directors knew they were not discharging their fiduciary obligations").

(n47)Footnote 47. 970 A.2d 235, 241 (Del. 2009) .

(n48)Footnote 48. *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 654 (Del. Ch. 2008) ; *see also In re Citigroup Inc. Shareholder Litig.*, 964 A.2d 106, 131 (Del. Ch. 2009) ; *McPadden v. Sidhu*, 964 A.2d 1262 (Del. Ch. 2008) .

(n49)Footnote 49. *See, e.g., AIG Consol. Deriv. Litig.*, 965 A.2d 763 (Del. Ch. 2009) (holding that complaint sufficiently pled that inside directors were consciously not doing their jobs and knowingly engaged in criminal conduct).

(n50)Footnote 50. 918 A.2d 341, 355 n.35 (Del. Ch. 2007) ; *see also id.* at n.59 ("Although the mechanics of backdating differs from the mechanics of spring loading, each practice encompasses an element of intentional dissembling, either as to the date of the option grant, or as to the existence of potentially favorable information unavailable to the market and to all other shareholders."); *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563 (Del. Ch. 2007) (concluding that granting spring loaded options without explicit authorization from shareholders is an "indirect deception" that violates the duty of loyalty).

(n51)Footnote 51. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) .

(n52)Footnote 52. *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) .

(n53)Footnote 53. *Caremark*, 698 A.2d at 968 .

(n54)Footnote 54. *Caremark*, 698 A.2d 959 .

(n55)Footnote 55. *Caremark*, 698 A.2d at 967 .

(n56)Footnote 56. *Caremark*, 698 A.2d at 970 .

(n57)Footnote 57. *Caremark*, 698 A.2d at 971 .

(n58)Footnote 58. *Caremark*, 698 A.2d at 970 .

(n59)Footnote 59. *Caremark*, 698 A.2d at 970 n.27 .

(n60)Footnote 60. *Caremark*, 698 A.2d at 970 n.27 .

(n61)Footnote 61. *Caremark*, 698 A.2d at 971 .

(n62)Footnote 62. *Caremark*, 698 A.2d at 963 .

(n63)Footnote 63. *Caremark*, 698 A.2d 959 .

(n64)Footnote 64. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) .

(n65)Footnote 65. *Caremark*, 698 A.2d at 970 .

(n66)Footnote 66. *Caremark*, 698 A.2d at 970 . See also *Teachers' Ret. Sys. v. Aidinoff*, 900 A.2d 654 (Del. Ch. 2006) ; *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003) ; *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795 (7th Cir. 2003) ; *ATR - Kim Eng Fin. Corp. v. Arwreta*, 2006 WL 3783520 (Del. ch. Dec. 21, 2006) (where chairman gutted company for personal gain, other directors, who did nto participate in, profit from, or approve of the scheme, were nevertheless liable for acting as "stooges" and failing to fulfill their duty of oversight). See generally William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors*, Ch. 3 (7th ed. Matthew Bender 2003).

(n67)Footnote 67. See NYSE Listed Company Manual § 303A.07(c)(i)(A)(2) (providing that the audit committee of each NYSE-listed company must have a written charter that addresses the committees purpose, which must be, "at a minimum," to assist board oversight of compliance with legal and regulatory requirements").

(n68)Footnote 68. See also Chapter 9 below, for detailed discussion of the audit committee.

(n69)Footnote 69. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) .

(n70)Footnote 70. *Aronson*, 473 A.2d at 812 ; accord *Bodell v. Gen. Gas & Elec. Corp.*, 140 A. 264 (Del. 1927) ; *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) ; William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors*, Ch. 2 (7th ed. 2003); E. Norman Veasey & Julie M. Seitz, *The Business Judgment Rule, The Model Act, The Trans Union Case and the ALI Project - A Strange Porridge*, 63 *Tex. L. Rev.* 1483 (1985); E. Norman Veasey, *Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process under Control?*, 40 *Bus. Law.* 1373 (Aug. 1985); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 *Bus. Law.* 1477 (Aug. 1984).

(n71)Footnote 71. *Del. Code Ann. tit. 8, § 141(a)* (2003); see *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (recognizing that "the business judgment rule ... is, of course, simply a recognition of the allocation of responsibility made by Section 141(a) of the Delaware General Corporation Law, and of the limited institutional competence of courts to assess business decisions").

(n72)Footnote 72. See *Solash v. Telex Corp.*, CAs 9518, 9528, 9525, 1988 *Del. Ch. LEXIS 7*, at *19 (Jan. 19, 1988) ("businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith").

(n73)Footnote 73. See E. Norman Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions*, 37 *Bus. Law.* 1247 (1982).

(n74)Footnote 74. See, e.g., *Angelo, Gordon, Co., L.P. v. Allied Riser Communications Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002) (stating that "to overcome the presumption of regularity attending the application of the business judgment rule plaintiffs must carry an initial burden of showing circumstances supporting an inference that the directors

did not act in good faith after a reasonable investigation") (footnote omitted); *see also Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361, modified, 636 A.2d 956 (Del. 1994) ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty--good faith, loyalty or due care"); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one").

(n75)Footnote 75. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1985) .

(n76)Footnote 76. *Aronson*, 473 A.2d at 813 .

(n77)Footnote 77. *See Aronson*, 473 A.2d at 812 , 816 ("director independence inheres in the conception and rationale of the business judgment rule").

(n78)Footnote 78. *Aronson*, 473 A.2d at 812 .

(n79)Footnote 79. *Aronson*, 473 A.2d at 812 .

(n80)Footnote 80. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.) , *aff'd*, 500 A.2d 1346 (Del. 1985) .

(n81)Footnote 81. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) ; *Dynamics Corp. of Am. v. CTS Corp.*, 637 F. Supp. 406 (N.D. Ill. 1986) , *aff'd*, 794 F.2d 250 (7th Cir. 1986) , *rev'd on other grounds*, 481 U.S. 69 (1987) .

(n82)Footnote 82. *See Unocal*, 493 A.2d at 955 ; *see also In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 474 (Del. Ch. 2000) ("When a board adopts measures designed to deter or defend against an acquisition offer and thereby also against the possibility that the board and management will lose their positions after the acquisition, there is an omnipresent specter that [the] board may be acting primarily in its own interests, rather than those of the corporation and its shareholders") (internal quotation omitted).

(n83)Footnote 83. *See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 932 (Del. 2003) (holding directors' proof of reasonable investigation is " 'materially enhanced' if it is approved by a board comprised of a majority of outside directors or by an independent committee"), *quoting Unocal*, 493 A.2d 946 ; *accord Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1343 (Del. 1987) ("[t]hus, with the independent directors in the majority, proof that the board acted in good faith and upon reasonable investigation is materially enhanced"); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (proof demonstrating that the directors have acted reasonably is "materially enhanced where ... a majority of the board favoring the proposal consisted of outside directors"); *Polk v. Good*, 507 A.2d 531, 537 (Del. 1986) (holding that the presence of 10 outside directors on a 13-member board, coupled with the receipt of outside investment banking and legal advice, constituted "a prima facie showing of good faith and reasonable investigation").

(n84)Footnote 84. *In re RJR Nabisco S'holders Litig.*, Consol. CA 10389, 1989 Del. Ch. LEXIS 9, at *39 (Jan. 31, 1989) .

(n85)Footnote 85. *See, e.g., Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986) ; *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279 n. 27 (Del. 1989) . The duty of loyalty is discussed in § 4.03[3] above.

(n86)Footnote 86. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 363-366 . Director self-interest is discussed in § 4.04[1] below.

(n87)Footnote 87. *See Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) ; *Aronson v. Lewis*, 473 A.2d 805, 812

(*Del. 1988*) (citing numerous cases); *see also Smith v. Van Gorkom*, 488 A.2d 858, 873 (*Del. 1985*).

(n88)Footnote 88. *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599, 611 (*Del. Ch. 1974*), *aff'd*, 316 A.2d 619 (*Del. 1974*); *see also Allau v. Consol. Oil. Co.*, 147 A. 257, 261 (*Del. Ch. 1929*) (requiring "reckless indifference to or a deliberate disregard of the stockholders").

(n89)Footnote 89. *See, e.g., In re Radiology Assocs., Inc., Litig., CA 9001, 1990 Del. Ch. LEXIS 58*, at **22-24 (May 16, 1990) (finding that board's decision to approve cash-out merger was based solely and unquestioningly upon clearly inadequate investigation of controlling stockholder); *see also Smith v. Van Gorkom*, 488 A.2d 858 (*Del. 1985*) (finding that board approved merger within hours of learning of proposal, after having only received a brief oral presentation that did not address the intrinsic value of the company).

(n90)Footnote 90. *See, e.g., McMullin v. Beran*, 765 A.2d 910, 922 (*Del. 2000*) (board first considered and approved merger agreement negotiated by controlling stockholder during the course of a single meeting); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (*Del. 1985*) (finding that directors "were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency"); *cf. Citron v. Fairchild Camera and Instrument Co.*, 569 A.2d 53, 66-67 (*Del. 1989*) (board satisfied duty of due care when, despite being forced to make final decision on offer within three-hour period, board had researched fair price of company and received independent opinions in months leading up to decision).

(n91)Footnote 91. *See Del. Code Ann. tit. 8, § 102(b)(7)* (2003); *see also § 5.02 below*, for discussion of exculpatory charter provisions.

(n92)Footnote 92. *See Del. Code Ann. tit. 8, § 102(b)(7)* (contemplating such provisions only "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages"). *See also Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 535, n.2 (*Del. 1996*) (noting that "Under 8 *Del.C. § 102(b)(7)*, directors are not exempt from equitable relief, but are exempt from liability for monetary damages unless an exception set forth in Section 102(b)(7) is applicable"); *Turner v. Bernstein*, 776 A.2d 530, 549 (*Del. Ch. 2000*) (noting that Section 102(b)(7) provisions "do not bar injunctive relief for duty of care violations").

(n93)Footnote 93. *See, e.g., Brehm v. Eisner*, 746 A.2d 244, 261 (*Del. 2000*) ("[i]t is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision"); *Cheff v. Mathes*, 41 *Del. Ch. 494*, 199 A.2d 548, 554 (*Del. Ch. 1964*) ("if the actions of the board were motivated by a sincere belief that [they were] necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course"); *Strassburger v. Earley*, 752 A.2d 557, 582 (*Del. Ch. 2000*) ("The business judgment rule shields directors from liability for good faith business decisions, even those that turn out to be mistaken"); *Reading Co. v. Trailer Train Co.*, CA 7422, 1984 *Del. Ch. LEXIS 499*, at **12-13 (Mar. 15, 1984) (acknowledging that a "board's decision, otherwise properly based, could be wrong and still withstand attack").

(n94)Footnote 94. *See Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1239 (*Del. Ch. 1988*) ("Where, as here, a corporate transaction is sought to be enjoined as a breach of fiduciary duty, the standard governing the propriety of that transaction will depend upon the context or setting in which it arises. If the transaction is approved by disinterested directors acting in good faith and pursuant to an appropriate deliberative process, the reviewing court will evaluate the transaction under the business judgment rule. Under that standard, the transaction is presumed to be valid, and the directors' decision will not be disturbed, so long as it can be attributed to any rational business purpose") (internal citations omitted); *AC Acquisitions Corp v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (*Del. Ch. 1986*) ("Ordinarily when a court is required to review the propriety of a corporate transaction challenged as constituting a breach of duty or is asked to enjoin a proposed transaction on that ground, it will, in effect, decline to evaluate the merits of wisdom of the transaction once it is shown that the decision to accomplish the transaction was made by directors with no financial interest in the transaction adverse to the corporation and that in reaching the decision the

directors followed an appropriately deliberative process").

(n95)Footnote 95. *See* Reading Co. v. Trailer Train Co., CA 7422, 1984 Del. Ch. LEXIS 499, at **12-13 (Mar. 15, 1984) ("The business judgment rule allows for the possibility that other people might disagree with a board's decision"); *accord* *Brehm v. Eisner*, 746 A.2d 244, 261 (Del. 2000).

(n96)Footnote 96. *In re J. P. Stevens & Co., Inc. S'holders Litig.*, 542 A.2d 770, 780-781, n. 5 (Del. Ch. 1988) (citations omitted). The Chancellor also directed the readers' attention to cases stating formulations of the rule against the "waste" of corporate assets, which reflected the view that such conduct was akin to actual or constructive fraud and therefore could not be protected by the business judgment rule. *J. P. Stevens*, 542 A.2d at 780-781, n. 5.

(n97)Footnote 97. *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599 (Del. 1974).

(n98)Footnote 98. *Gimbel*, 316 A.2d at 608.

(n99)Footnote 99. *Gimbel*, 316 A.2d at 609. The phrase "rational business purpose" was first introduced by the Delaware Supreme Court in *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). The test seemingly implied by the phrase did not form a part of the court's analysis in that case.

(n100)Footnote 100. *Gimbel*, 316 A.2d at 611.

(n101)Footnote 101. *See* Kahn v. Roberts, CA 12324, 1995 Del. Ch. LEXIS 151, at *11 (Dec. 6, 1995) (defining "gross negligence" as "reckless indifference to or a deliberate disregard of the whole body of stockholders or [engaging in] actions which are without the bounds of reason"), *quoting* Tomczak v. Morton Thiokol, Inc., CA 7861, 1990 Del. Ch. LEXIS 47 at 35 (Apr. 5, 1990).

(n102)Footnote 102. *See generally* the cases cited in the discussion of "good faith" in § 4.03[1] above.

(n103)Footnote 103. *Gimbel*, 316 A.2d at 614.

(n104)Footnote 104. If not enjoined, the subsidiary would be sold for \$480 million. The plaintiff's expert opined that its true fair market value was \$761 million. The defendant's expert, in contrast, claimed the subsidiary was only worth \$410 million. The court was clearly impressed by this discrepancy, stating that the estimates were "at such variance as to suggest that someone may be dead wrong." *Gimbel*, 316 A.2d at 617.

(n105)Footnote 105. *Gagliardi v. Trifoods Int'l., Inc.*, 683 A.2d 1049, 1052 n. 5 (Del. Ch. 1996) (emphasis in original).

(n106)Footnote 106. *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

(n107)Footnote 107. *See, e.g.,* *Brehm v. Eisner*, 746 A.2d 244, 260 (Del. 2000) (stating that "[i]t is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except in rare cases [where] a transaction may be so egregious on its face that it suffices to rebut the business judgment presumption") (internal quotation omitted); *Levine v. Smith*, 591 A.2d 194, 205-206 (Del. 1991) ("[a]ssuming a plaintiff cannot prove that directors are interested or otherwise not capable of exercising independent business judgment, a plaintiff in a demand futility case must plead particularized facts creating a reasonable doubt as to the soundness of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction").

(n108)Footnote 108. *See, e.g.,* *Rothenberg v. Santa Fe Pac. Corp.*, CA 11749, 1995 Del. Ch. LEXIS 117, at *18 (Sept. 5, 1995) (excusing demand where an allegedly wasteful distribution of 1.15 million shares of stock for no consideration was without a "rational business purpose"); *Lewis v. Hett*, CA 6752, 1984 Del. Ch. LEXIS 546, **10-11 (Sept. 4, 1984) (excusing demand where lucrative severance agreement was allegedly given for no consideration, creating "a reasonable doubt that the severance payments constitute a gift or waste of corporate assets and, therefore,

that the challenged transaction was ... the product of a valid exercise of business judgment"); *see also* London v. Tyrrell, No. 3321, 2008 WL 2505435 (Del. Ch. June 24, 2008) (excusing demand where directors stood on both sides of the transaction by both granting and receiving stock options at issue and facts alleged in complaint supported inference that directors knowingly violated fair market value provisions of stockholder-approved option plan).

(n109)Footnote 109. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812-813 n.6 (Del. 1984) (citing "gross and palpable overreaching" language in Delaware cases in support of the proposition that director liability is predicated on gross, rather than simple, negligence); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971) (upholding board's decision as "one of business judgment with which a court will not interfere absent evidence of gross and palpable overreaching").

(n110)Footnote 110. *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. 1967) .

(n111)Footnote 111. *Case v. New York Central Railroad Co.*, 243 N.Y.S. 2d 620 (App. Div. 1963) , *rev'd*, 243 N.Y.S. 2d 620 (App. Div. 1965) .

(n112)Footnote 112. *See, e.g., Schreiber v. Bryan*, 396 A.2d 512, 519 (Del. Ch. 1978) (stating that business judgment rule would apply in parent-subsidiary context, absent showing of "gross and palpable overreaching," where parent did not stand on both sides of the transaction and engage in self-dealing); *Trans World Airlines, Inc. v. Summa Corp.*, 374 A.2d 5 (Del. Ch. 1977) (same); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (applying business judgment rule to parent's decisions to cause subsidiary to pay dividends and to parent's allocation of opportunities among subsidiaries, where there was no self-dealing or other evidence of "gross and palpable overreaching"); *accord Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970) (applying business judgment rule to parent's decision not to share allocation of oil imports under federal law, because the government rather than the parent fixed the terms of the transaction and there was otherwise no evidence of "gross and palpable overreaching"); *but see In re Primedia, Inc. Derivative Litig.*, 910 A.2d 248, 259 (Del. Ch. 2007) (concluding minority shareholders stated claim for overreaching where controlling stockholder caused its preferred stock to be called at full redemption price years early).

(n113)Footnote 113. *See* § 4.03[5][a] above.

(n114)Footnote 114. This is perhaps evidenced by the *Aronson* court's citation to the phrase in support of its holding that a gross, rather than simple, negligence standard should apply to determine directors' liability for breaches of the duty of care. *See Aronson*, 473 A.2d at 812-13 . The "gross and palpable overreaching" formulation also surfaced in the analysis of whether appraisal provides an adequate remedy for a cash-out merger. *See, e.g., Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 714 (Del. 1983) (stating that "[t]he appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved").

(n115)Footnote 115. *In re The Walt Disney Co. Derivative Litig.*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) .

(n116)Footnote 116. *Disney*, 2005 Del. Ch. LEXIS 113, at *4 .

(n117)Footnote 117. *In re Netsmart Tech., Inc. S.holders Litig.*, 924 A.2d 171, 191 (Del. Ch. 2007) (noting that approval of minutes several months after meeting was "to state the obvious, not confidence-inspiring.").

(n118)Footnote 118. E. Norman Veasey, *Economics and Investor Expectations in Corporate Law*, The Metropolitan Corporate Counsel 1 (April 1998). The new listing standards of certain stock exchanges, along with the Sarbanes-Oxley Act of 2002, attempt to impose similar best practices upon boards of directors. The new listing standards of the New York Stock Exchange include, among other things, the following requirements: (i) a majority of independent directors on the board of each company, (ii) regularly scheduled meetings of non-management directors, (iii) entirely independent nominating/corporate governance committee, (iv) entirely independent compensation

committee, (v) heightened independence of audit committee members, (vi) expanded authority of audit committees, and (vii) corporate governance guidelines. These new listing standards are set forth in NYSE Listed Company Manual § 303A, Corporate Governance Standards, which is reproduced in Appendix B to this treatise. *See also* William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* § 13.14[3] (7th ed. 2003).

(n119)Footnote 119. E. Norman Veasey, *Economics and Investor Expectations in Corporate Law*, The Metropolitan Corporate Counsel 1 (April 1998) (noting that adherence to the "aspirational norms" does not "necessarily preordain any particular result" but "at best may be in the nature of safe harbors in certain circumstances").

(n120)Footnote 120. *In re The Walt Disney Co. Derivative Litig.*, 2005 Del. Ch. LEXIS 113, at *191 & n.487 (Aug. 9, 2005).

(n121)Footnote 121. *Disney*, 2005 Del. Ch. LEXIS 113, at *191-193 .

(n122)Footnote 122. *Disney*, 2005 Del. Ch. LEXIS 113, at *216 .

(n123)Footnote 123. *Disney*, 2005 Del. Ch. LEXIS 113, at *194-195 .

(n124)Footnote 124. *Disney*, 2005 Del. Ch. LEXIS 113, at *202 n.504 .

(n125)Footnote 125. *Disney*, 2005 Del. Ch. LEXIS 113, at *122-123 .

(n126)Footnote 126. *Disney*, 2005 Del. Ch. LEXIS 113, at *118-119 .



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Corporate Governance: Law and Practice

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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.04

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§ 4.04 The Effect of Director Interest or Lack of Independence

As discussed above, a condition to a board's decision receiving deferential review under the business judgment rule is that the individual directors making the decision be disinterested and independent. This means that business decisions made by boards of directors must be based "entirely on the corporate merits of the transaction and ... not influenced by personal or extraneous considerations."¹ While directors' interest and lack of independence are distinct concepts, both share a similar concern with possible influences on judgment that create a particular risk of compromising a director's unremitting duty of loyalty to the corporation and its stockholders.

[1] Interested Directors

The paradigmatic cases of self-interest occur when corporate fiduciaries deal directly with the corporations to which they owe a duty of loyalty. Such classic self-dealing occurs when a corporate fiduciary is "on both sides of a transaction."² That is, when a corporate fiduciary "deals directly with the corporation, or has a stake in or is an officer or director of a firm that deals with the corporation."³ For example, a director engages in self-dealing when he or she is a partner in a firm that purchases property from the corporation.⁴ Self-dealing would also exist where a director sells property to the corporation.⁵ In cases such as these, a director's personal self-interest in (and natural inclination toward) maximizing the value of the deal will conflict with the continuing obligation to serve the best interest of the corporation. Because of this conflict, and the frequent attendant circumstance of a lack of arm's length negotiations otherwise supporting the fairness of the deal, Delaware courts conclusively presume that self-dealing directors cannot judge the corporate merits of the transaction in a disinterested manner. Thus, such self-dealing directors are deemed "interested" in the transaction regardless of the likelihood that such personal or extraneous influences might actually cause disloyal behavior or otherwise harm the corporation.⁶ Because self-dealing directors are conclusively presumed to be interested, the business judgment rule does not apply to their decisions.

Even where a director does not appear on both sides of a transaction, a director may be deemed interested in a corporation's transaction with a third party in virtue of having a material financial interest in the transaction that is not generally shared with stockholders.⁷ Unlike cases of classic self-dealing, where a director is *per se* interested, a director's unshared financial interest in a third-party transaction is only debilitating when it is material.⁸ Interest is not created by the mere fact that a director generally has had some business or commercial affiliations with the party

adverse to the corporation, without some showing that such dealings created a material unshared financial interest in a particular transaction.ⁿ⁹

The standard for determining whether a fiduciary's financial interest is material is a subjective test: whether, in the context of the particular fiduciary's economic circumstances, the fiduciary was or would likely be affected by that financial interest.ⁿ¹⁰ This subjective test requires the reviewing court to examine the record for evidence that a particular allegedly interested fiduciary would be especially immune from or susceptible to opportunities for self-enrichment, or would otherwise behave differently than a reasonable person in the situation.ⁿ¹¹ Unshared economic benefits are not sufficient to create director self-interest when, in the fiduciary's particular circumstances, their value is *de minimis*.ⁿ¹²

As this subjective standard suggests, "the question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case."ⁿ¹³ Nonetheless, several clear principles have emerged. First, the mere ownership of a substantial number of shares of stock does not suffice to create director self-interest. In fact, it tends to align director's interests with those of shareholders.ⁿ¹⁴ Second, the mere fact that one or more directors will retain their present board memberships following a transaction is insufficient as a matter of law to create director self-interest.ⁿ¹⁵ And, relatedly, the mere post-transaction receipt of normal director's fees fails to show director interest as a matter of law.ⁿ¹⁶

Otherwise, a court applying the above "unshared material financial benefit" test is likely to estimate the magnitude of the fiduciary's divergent financial interests in the particular transaction. A fiduciary is clearly self-interested with regard to a merger, for example, where he is also the chairman of a consulting company that is employed and paid seven-figure sums to effectuate the merger.ⁿ¹⁷ Similarly, fiduciaries with stock options were interested in a decision to cancel options and pay option-holders the difference between their exercise price and the pro rata price of a related tender offer.ⁿ¹⁸

Even though a fiduciary's stock ownership tends to align the fiduciary's interests with general shareholder interests, other conflicting interests of director-stockholders may make them materially self-interested. In *Ryan*, for example, minority shareholders alleged that controlling shareholders (who also were corporate directors) had a material unshared financial interest in connection with an asset sale.ⁿ¹⁹ In 1986, third-party purchasers offered to buy the corporation's assets for \$11 million dollars. Related agreements with the directors would pay them \$2 million for refraining from competition and for giving advice when requested. When the stock market declined in October 1987, the purchasers reduced their offer for the corporate assets to \$9.75 million dollars, but the directors' related agreements remained unchanged.ⁿ²⁰ The court considered the asset sale and the concurrent non-competition/consultant agreements to be different aspects of the same transaction.ⁿ²¹ Had the \$2 million non-compete payment been paid directly to the corporation, the directors' pro rata share would only have been approximately \$1.5 million. This \$500,000 difference amounted to a 7 percent premium above the directors' pro rata share from the sale of the assets alone and was equal to twice the directors' combined annual salaries. Accordingly, it was deemed a sufficiently material interest to cause them to negotiate the \$2 million as a direct side payment to themselves, to the neglect of the minority shareholders.ⁿ²²

[2] Independent Directors

Like director interest, the inquiry into director independence is ultimately concerned with a corporate fiduciary's ability to focus on the corporate merits of a particular decision, rather than "extraneous considerations or influences."ⁿ²³ Whereas a debilitating self-interest flows from a directors' role or financial stake in a transaction, directors lack independence in virtue of certain types of relationships to others who are the proponents of, or are otherwise "interested" in, a given transaction.ⁿ²⁴ Specifically, such problematic relationships exist when a director is " beholden " to a person or entity that is interested in, or a strong supporter of, the challenged transaction.ⁿ²⁵ This fact-intensive inquiry considers and assesses the likely impact of any substantial influence the interested party (or proponent of a transaction) could assert over a director, in light of the particular circumstances of that director.ⁿ²⁶ Whereas an inquiry

into director interestedness focuses on conflicts presented by a specific transaction, a determination of director independence focuses on general influences on business judgment.ⁿ²⁷

Lack of independence is most commonly found when a director is beholden to interested persons for the continued receipt of a financial benefit that is material in the particular director's circumstances.ⁿ²⁸ Courts have taken into account a director's close relationship with third parties whose financial well-being could be materially harmed by interested persons.ⁿ²⁹ The mere fact that a director has been appointed by an interested party, and therefore may be dependent upon such person for the continued receipt of normal directors' fees, does not suffice to show a lack of independence.ⁿ³⁰ Similarly, the mere fact of various business relationships, absent a showing of control over a directors' material financial interest, generally does not indicate a lack of independence.ⁿ³¹

Courts have generally been reluctant to find that the presence of a personal relationship, without the influence of possible financial retribution, suffices to show a lack of independence.ⁿ³² Arguments supposing "the professional and social relationships that naturally develop among members of a board impede independent decisionmaking" will be rejected.ⁿ³³ Nevertheless, cases weigh the presence of strong personal or familial ties in assessing likely influences upon directors' judgment.ⁿ³⁴ Past decisions by directors that suggest a willingness to cede control to a certain favored self-interested person may suggest a lack of independence.ⁿ³⁵

Perhaps the most significant recent independence case, and one that exemplifies the extremely fact-intensive nature of this inquiry, is the Court of Chancery's decision in *In re Oracle Corp. Derivative Litigation*, which held that directors' "shared material affiliations" may in some circumstances create doubts regarding their independence.ⁿ³⁶ There, the allegedly "beholden" directors were two members of the senior faculty at Stanford University, who were a Special Litigation Committee (the "SLC") formed to investigate alleged breaches of fiduciary duty stemming from insider trading by Oracle senior executives, including four members of its board of directors.ⁿ³⁷ After an investigation that involved more than seventy witness interviews, resulted in a more than 1,100 page report, and which the Court characterized as "extensive ... by any objective measure," the committee found the suit to be meritless, and moved to terminate the litigation.ⁿ³⁸ In order for its motion to be granted, the SLC had to show that there was no material issue of fact calling into doubt its independence.ⁿ³⁹

Discovery into the committee's independence revealed numerous ties between the defendant directors and Stanford. Like the SLC members, one defendant director was also a senior faculty member at Stanford, who had taught one of the two SLC members in graduate school at Stanford.ⁿ⁴⁰ The defendant director and his former student remained in contact over the years, and both were currently senior fellows at a Stanford research center.ⁿ⁴¹ Another of the defendant directors was a "very loyal alumnus" of Stanford who had personally donated over \$600,000 to the school and had chaired a foundation that donated an additional \$11.7 million. Among his personal donations was a \$50,000 grant in appreciation for a speech given by one of the SLC members at Stanford's law school.ⁿ⁴² A third defendant-director, the founder of Oracle, was one of the wealthiest men in America. One of his charitable foundations had donated approximately \$10 million to Stanford. During his tenure as Oracle's CEO, the company made \$300,000 in additional donations to Stanford. At the time the allegations of insider trading began to surface, media sources reported that he was considering an \$150 million donation to Stanford, as well as leaving his \$100 million home to Stanford at his death.ⁿ⁴³ The court noted its "shock" at learning these facts, none of which were disclosed in the SLC's report.ⁿ⁴⁴

The court began its analysis by emphasizing that directors can be beholden to controlling persons by virtue of having influence over factors other than the directors' financial well-being: "Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*."ⁿ⁴⁵ The court then framed the "beholden" inquiry in light of "the social nature of humans," observing that "corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that explicitly and implicitly, influence and channel the behavior of those who participate in their operation."ⁿ⁴⁶ In particular, the court recognized "the extreme importance and difficulty of [a special litigation committee's] responsibility," observing that it is easier "to

say no to a friend, relative, colleague, or boss who seeks assent for an act (*e.g.*, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person."ⁿ⁴⁷ If the SLC decided there was cause to pursue the insider trading claims, it would expose their colleagues to "the possibility of a large damage award" and "great reputational harm."ⁿ⁴⁸ Finally, the court thought it significant that the SLC would have to judge whether their colleagues acted with a culpable state of mind.ⁿ⁴⁹

Taking all this into account, the court held that the SLC could not show that there was no material fact calling into doubt its independence. With regard to the defendant director who, like the SLC members, was a member of Stanford's faculty and had taught one of the SLC members, the court found that "a general sense of human nature" suggested that the SLC members would ponder their personal ties and mutual affiliations when making their decision.ⁿ⁵⁰ With regard to the director defendant who was an alumnus of and large contributor to Stanford, the court also found it likely that the SLC members would consider the effect of their decision on Stanford's relationship with him. Although the SLC members argued they were unaware what a large donor he had been, the court found that this was improbable, and in any event their ignorance undermined confidence in their investigation.ⁿ⁵¹ The court rejected the SLC's argument that, given Stanford's immense financial resources, the donations of one person could not constitute a "material" financial benefit. In doing so, the court stated that "[e]ndowments and buildings grow one contribution at a time," and noted that Stanford's various means of expressing gratitude, *e.g.*, naming buildings after large donors, suggested such donations were important to it.ⁿ⁵² Finally, with regard to Oracle's founder, one of the wealthiest men in America who made large donations to Stanford, the court found his beneficence to Stanford sufficient to create doubt as to the SLC's independence. The court was also clearly impressed by how difficult it would be bring claims against a person of his stature, who was a dominant presence in the community in which he and the SLC members lived.ⁿ⁵³ Because the court found these facts would "be on the mind of the SLC members in a way that generates an unacceptable risk of bias," it denied the SLC's motion to terminate the litigation. A lack of independence would always require this result, regardless of the "subjective good faith and the reasonableness of [the SLC's] conclusions."ⁿ⁵⁴

In the recent case of *Beam v. Stewart*, however, the Delaware Supreme Court suggested that *Oracle* and other cases addressing the independence of special litigation committees may have limited precedential value outside the SLC context.ⁿ⁵⁵ In distinguishing *Oracle*, the Court reasoned that, unlike directors in a demand futility case, the members of an SLC bear the burden of proving their independence. It also reasoned that the issue of an SLC's independence only arises after a pre-suit demand has been excused, in the context of deciding whether to dismiss an otherwise valid derivative claim. The Court simply stated, without supporting analysis, that *Oracle* was distinguishable on its facts.ⁿ⁵⁶ While the Court expressly refused to decide whether the substantive test of independence is greater in the SLC context, its broad manner of distinguishing *Oracle* would certainly support this conclusion.

In *Beam*, the Delaware Supreme Court pointed out the serious risk a director would take in protecting a social acquaintance at the possible expense of the destruction of that director's hard-earned reputation. Thus, *Beam* held, not only must such allegations be factually specific, they must support a reasonable inference that the director was more willing to risk his or her reputation than the relationship. The Court, however, stated that some professional or personal friendships which "border on or even exceed familial loyalty and closeness" may establish demand futility.^{n56.1} Reasonable doubt as to director independence might arise "either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis-a-vis an interested director."^{n56.2}

[3] Special Situations Influencing Directors' Business Judgment

[a] Dual Fiduciaries

So-called "dual fiduciary" situations involve classic self-dealing. In such situations, a corporate fiduciary serves on the boards of two or more corporations that may deal with one another. This predicament arises most frequently in the parent and non-wholly owned subsidiary context.ⁿ⁵⁷

"There is no dilution of [fiduciary] obligations where one holds dual or multiple directorships, as in a parent-subsiary context. Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations."ⁿ⁵⁸ Where possible, the dual fiduciary must act to further the best interests of both corporations, thereby satisfying the duty of loyalty to each of the corporations he or she serves.ⁿ⁵⁹ In such situations, the directors need not abstain from any board deliberations and may participate in the decision-making process. In some circumstances, however, such as when the corporations deal with one another or when the board of one corporation is considering action that would harm the other, the interests of the two corporations will be in direct conflict, such that there is no course of action that is in both of their best interests. In these circumstances, the dual fiduciary is not required to but should either abstain from voting or refrain from participating in decision making for either company.ⁿ⁶⁰

[b] Controlling Stockholders' Self-Dealing

Where a controlling stockholder "stands on both sides of a transaction," the business judgment rule will not apply to protect directors' decisions, regardless of the directors' disinterest or independence.ⁿ⁶¹ A stockholder is deemed to have control over a corporation when he or she (i) owns a mathematical majority of the voting power of a corporation's outstanding stock or (ii) otherwise exercises control over its business affairs.ⁿ⁶² While the inquiry into whether a stockholder has a "controlling" status will sometimes overlap with the normal inquiry into director independence,ⁿ⁶³ it is possible for a stockholder to be deemed in control of otherwise disinterested and independent directors.ⁿ⁶⁴ This result stems from the "inherent coercion" from the controlling stockholder, who will continue to dominate the company after a transaction and who may retaliate against or replace directors who act against its wishes.ⁿ⁶⁵ As the Court of Chancery has colorfully explained, Delaware law views the "controlling stockholder as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)."ⁿ⁶⁶ In such circumstances, the business judgment rule will not apply, as courts deem directors to be incapable of fulfilling their obligation to act in the best interests of all of the corporation's stockholders.ⁿ⁶⁷

To the extent the courts' unwillingness to rely on directors' business judgment in controlling stockholder transactions is based on the mere fact directors might lose their board positions, this is in tension with the maxim that, to be debilitating, the potential financial loss must be material in the particular director's circumstances.ⁿ⁶⁸

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law
 Corporations
 Directors & Officers
 Management Duties & Liabilities
 Causes of Action
 Self-Dealing
 Business & Corporate Law
 Corporations
 Directors & Officers
 Management Duties & Liabilities
 Defenses
 Business Judgment Rule
 Business & Corporate Law
 Corporations
 Directors & Officers
 Management Duties & Liabilities
 Fiduciary Responsibilities
 Duty of Loyalty

FOOTNOTES:

(n1)Footnote 1. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) ; see also the discussion of the duty of loyalty at § 4.03[3] above .

(n2)Footnote 2. *Sinclair Oil. Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) .

(n3)Footnote 3. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1169 (Del. 1995) (citing *Del. Code Ann. tit. 8, § 144(a)* (2003)). As discussed in greater detail below, Section 144 of the Delaware General Corporation Law provides a statutory "safe-harbor" for transactions that would be voidable at common law.

(n4)Footnote 4. See *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94 (Del. Ch. 1999) ; see also *Harbor Fin.*

Partners v. Huizenga, 751 A.2d 879, 887 (Del. Ch. 1999) (self-dealing, within rubric of Section 144, present where four of seven directors held substantial stock interest in merger target).

(n5)Footnote 5. See *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964) (providing example).

(n6)Footnote 6. See *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 113-114 (Del. Ch. 1999) (holding that directors are inherently interested in self-dealing transactions, regardless of the magnitude or strength of the personal or external influence in the particular transaction); *Cede Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) (distinguishing between "classic self-dealing" and a third-party arm's length transaction in which directors have a material financial interest); *But see, Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 887 n. 20 (Del. Ch. 1999) (stating, in dicta, "[t]here is analytic force to the argument that Section 144 should, like many statutes, be read as incorporating a 'materiality' element. Such an element would ensure that a director who, for example, owns one share of stock worth \$100 or even \$1,000, in another entity with which the corporation of which he is a fiduciary is transacting business is not considered 'interested' ").

(n7)Footnote 7. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134 (Del. Ch. 1994) , *aff'd*, 663 A.2d 1156, 1169 (Del. 1995) ; *see, e.g., Siegman v. Tri-Star Pictures, Inc.*, CA 9477, 1989 Del. Ch. LEXIS 56 (May 5, 1989, revised May 30, 1989) (finding reasonable doubt of director disinterest where directors of target corporation owned stock in acquiror and plan of agreement required acquiror to pay a special dividend post-combination); *cf. Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (holding that directors were not interested in standstill agreement under which a dividend would be paid to all stockholders on a *pro rata* basis). Careful readers will see that the *Siegman* holding falls within the language of Section 144 and so may rightly be considered a case of "self-dealing" that renders a director per se "interested" regardless of the magnitude of his financial interest in the transaction. *Siegman* was decided before Delaware cases began to equate any Section 144 transaction with self-dealing. If *Siegman* was argued today, the plaintiffs' counsel could make a strong argument for *per se* interestedness, without regard to the materiality inquiry described below.

(n8)Footnote 8. See *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 113-114 (Del. Ch. 1999) ; *see generally Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362-363 (Del. 1993) .

(n9)Footnote 9. See, e.g., *Haber v. Bell*, 465 A.2d 353, 358 (Del. Ch. 1983) .

(n10)Footnote 10. *Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995) ; *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2000) ; *Ryan v. Tad's Enters., Inc.*, 709 A.2d 682, 689 (Del. Ch. 1996) , *aff'd*, 693 A.2d 1082 (Del. 1997) .

(n11)Footnote 11. *Cinerama*, 663 A.2d at 1167 .

(n12)Footnote 12. See, e.g., *Kidsco Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch. 1995) (holding director's interest in receiving payments for up to one day per month's consulting work was *de minimis* when compared with director's interest in maximizing the value of his 15.7 percent equity stake in the corporation), *aff'd*, 670 A.2d 1338 (Del. 1995) ; *see also Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 595 (Del. Ch. 1986) (holding \$1.3 million interest in a licensing agreement was *de minimis* when compared with controlling shareholder's interest in maximizing the value of his 70 percent ownership of stock in the corporation, which was worth \$300 million).

(n13)Footnote 13. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1993) .

(n14)Footnote 14. See *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355-56 (Del. Ch. 1998) *aff'd in part, rev'd in part on other grounds sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ; *In re Anderson, Clayton S'holders Litig.*, 519 A.2d 680, 687 (Del. Ch. 1986) (explaining that a directors' receipt of substantial benefits from a transaction "*qua* shareholder does not establish a disabling conflict for such persons *qua* directors in a transaction that will treat all shareholders equally"); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) ("Nor does

this become an "interested" director transaction merely because certain board members are large stockholders. As this Court has previously noted, that fact alone does not create a disqualifying 'personal pecuniary interest' to defeat the operation of the business judgment rule"), quoting *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964) (same); *Smith v. Good Music Station, Inc.*, 129 A.2d 242, 246-247 (Del. Ch. 1957) (holding the directors were not interested in allegedly wasteful asset sale in virtue of ancillary consulting agreements with purchaser, under which directors would receive less than their current pay, when their high level of stock ownership ensured they would want to maximize price of sale).

(n15)Footnote 15. *Orman v. Cullman*, 794 A.2d 5, 29 (Del. Ch. 2002) .

(n16)Footnote 16. See *Orman*, 794 A.2d at 29-30 ; see also, *Day v. Quotron Sys., Inc.*, CA 8502, 1989 Del. Ch. LEXIS 164 , at **19-20 (Nov. 20, 1989) (stating acquirers' plan to keep existing board with continued payment of normal directors' fees post-transaction did not render board interested in acquisition).

(n17)Footnote 17. *Orman*, 794 A.2d at 30-31 .

(n18)Footnote 18. *Kaufman v. Belmont*, 479 A.2d 282, 288 (Del. Ch. 1984) (noting that option-holding directors each received \$123,017 as a result of the cancellation decision).

(n19)Footnote 19. *Ryan v. Tad's Enters.*, 709 A.2d 682 (Del. Ch. 1996) .

(n20)Footnote 20. *Ryan*, 709 A.2d at 686 .

(n21)Footnote 21. *Ryan*, 709 A.2d at 686 , 706 n.9.

(n22)Footnote 22. *Ryan*, 709 A.2d at 689-690 .

(n23)Footnote 23. *Orman v. Cullman*, 794 A.2d 5, 24 (Del. Ch. 2002) , quoting *Aronson v. Lewis*, 473 A.2d 805, 816 ; see also *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (stating the focus is on "impartiality and objectivity").

(n24)Footnote 24. See, e.g., *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1990) ("[w]hen lack of independence is charged, a plaintiff must show that the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is 'sterilize[d]' ") quoting *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981) ; *Friedman v. Beningson*, CA 12232, 1995 Del. Ch. LEXIS 154, at *12 (Dec. 4, 1995) (stating that the independence inquiry looks to the influence of a person "with a material financial interest in the transaction under attack, which interest is adverse to that of the corporation").

(n25)Footnote 25. See, e.g., *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 928-929 (Del. Ch. 2003) ("a director may be compromised if he is beholden to an interested person"); *Rales v. Blasband*, 634 A.2d 927, at 936 (Del. 1993) (proving a lack of independence requires showing that directors are so "beholden" to controlling persons "or so under their influence that their discretion would be sterilized").

(n26)Footnote 26. See *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000) (stating that an assessment of director independence requires a subjective "actual person" standard to determine whether a "given" director was likely to be affected in the same or similar circumstances); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (stating that "the question of independence turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind") (emphasis in original) (citation omitted); *Friedman*, 1995 Del. Ch. LEXIS 154 at *12 (stating that a court must inquire "into all of the circumstances that are alleged to have inappropriately affected board power").

(n27)Footnote 27. See *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984) ("[t]he question of independence flows from an analysis of the factual allegations pertaining to the influences upon the directors' performance of their duties generally,

and more specifically in respect to the challenged transaction").

(n28)Footnote 28. *See, e.g., Rales v. Blasband*, 634 A.2d 927, 937 (Del. 1993) (finding reasonable doubt that insider director was independent when interested directors could "exert considerable influence" over his continued employment at a \$1 million per year); NC, 2002 Del. Ch. LEXIS 71 , **14-15 (June 14, 2002) (finding long-standing business relationship, where director served on boards and as a short-term executive at several of interested party's companies, supported lack of independence); *Steiner v. Meyerson*, CA 13139, 1997 Del. Ch. LEXIS 88 (June 13, 1997) (finding small law firm's receipt of \$1 million per year from corporation was a substantial material benefit to a partner, which could be terminated at the behest of an interested CEO); *Friedman v. Benningson*, CA 12232, 1995 Del. Ch. LEXIS 154 at **13-16 (Dec. 4, 1995) (finding \$48,000 annual consulting fees to be a material financial interest that could be put in jeopardy by disagreeing with interested 36 percent stockholder/CEO).

(n29)Footnote 29. *See, e.g., Rales v. Blasband*, 634 A.2d 927, 937 (Del. 1993) (finding the fact that director's brothers' continued employment was controlled by interested party supported lack of independence); *California Pub. Employees Ret. Sys. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144 at **28-29, (Dec. 18, 2002) (finding fact that director's son was a restaurant manager for a corporation for which interested party was CEO supported lack of independence).

(n30)Footnote 30. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) ; *In re The Limited, Inc. S'holders Litig.*, CA 17148- NC, 2002 Del. Ch. LEXIS 28, at *7 (Mar. 27, 2002) (stating that "[a]llegations as to one's position as a director and the receipt of director's fees," without more, however, are not enough "to show a reasonable doubt of independence"); *accord In re KDI Corp. S'holders Litig.*, CA 10278, 1990 Del. Ch. LEXIS 201 at *12 (Dec. 13, 1990) .

(n31)Footnote 31. *See, e.g., Stein v. Orloff*, CA 7276, 1985 Del. Ch. LEXIS 418 (May 30, 1985) , *appeal refused*, 504 A.2d 572 (Del. 1986) .

(n32)Footnote 32. *See, e.g., Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence"); *California Pub. Employees Ret. Sys. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144 at *29, n. 16 (Dec. 18, 2002) (stating that "personal friendships, without more ... [are] insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment," and citing cases); *see generally, Kells-Murphy v. McNiff*, 1991 Del. Ch. LEXIS 127 at *7 (July 12, 1991) (observing that "[w]here, as here, a majority of the board is (presumptively) not economically beholden to the officer or director who has an economic interest in the challenged transaction, it is understandably difficult to plead facts establishing that those directors are dominated or controlled").

(n33)Footnote 33. *Beam*, 845 A.2d at 1050-51 .

(n34)Footnote 34. *See, e.g., California Pub. Employees Ret. Sys., Inc. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144 at *28 (Dec. 18, 2002) (finding director's "lifelong" friendship with interested party supported lack of independence); *In re Cooper Co., Inc. S'holders Deriv. Litig., Consol. CA 12584*, 2000 Del. Ch. LEXIS 158 at *5 (Oct. 31, 2000) (director's relationship as father-in-law of interested person created reasonable doubt that he lacked independence); *In re NVF Co. Litig., Consol. CA 9050*, 1989 Del. Ch. LEXIS 167 at *7, *13-16 (Nov. 21, 1989) (taking into account family relationship between directors and interested party who engaged in classic self-dealing).

(n35)Footnote 35. *See, e.g., Kells-Murphy v. McNiff*, 1991 Del. Ch. LEXIS 127 at *7 (July 12, 1991) (finding board's prior (i) vote to award stock bonuses permitting person to become majority stockholder and (ii) acquiescence in that person's later taking of corporate opportunities created a reasonable doubt as to their independence); *cf. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 980-81 (Del. Ch. 2003) (stating, in rejecting argument that friendship with interested controlling stockholder created lack of independence, that there was no evidence of any inclination by director to disregard fiduciary duties).

(n36)Footnote 36. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 947 (Del. Ch. 2003) .

(n37)Footnote 37. *Oracle*, 824 A.2d at 921-925 .

(n38)Footnote 38. *Oracle*, 824 A.2d at 925-928 .

(n39)Footnote 39. *Oracle*, 824 A.2d at 920 .

(n40)Footnote 40. *Oracle*, 824 A.2d at 931 .

(n41)Footnote 41. *Oracle*, 824 A.2d at 931 .

(n42)Footnote 42. *Oracle*, 824 A.2d at 931-32 .

(n43)Footnote 43. *Oracle*, 824 A.2d at 932-935 .

(n44)Footnote 44. *Oracle*, 824 A.2d at 929 .

(n45)Footnote 45. *Oracle*, 824 A.2d at 938 .

(n46)Footnote 46. *Oracle*, 824 A.2d at 938 .

(n47)Footnote 47. *Oracle*, 824 A.2d at 940 .

(n48)Footnote 48. *Oracle*, 824 A.2d at 941 .

(n49)Footnote 49. *Oracle*, 824 A.2d at 941 .

(n50)Footnote 50. *Oracle*, 824 A.2d at 943 .

(n51)Footnote 51. *Oracle*, 824 A.2d at 943-944 , 947 ("[w]hether the SLC members had precise knowledge of all the facts that have emerged is not essential, what is important is that by any measure this was a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it").

(n52)Footnote 52. *Oracle*, 824 A.2d at 945 .

(n53)Footnote 53. *Oracle*, 824 A.2d at 945 ("[t]he notion that anyone in Palo Alto can accuse Ellison of insider trading without harboring some fear of social awkwardness seems a stretch [A]ccusing such a significant person in that community of such serious wrongdoing is no small thing").

(n54)Footnote 54. *Oracle*, 824 A.2d at 947-948 .

(n55)Footnote 55. *Beam v. Stewart*, 845 A.2d 1040, 1054-55 (Del. 2004) .

(n56)Footnote 56. *Beam*, 845 A.2d at 1055 .

(n57)Footnote 56.1. *Beam*, 845 A.2d at 1050 (quoting *Beam v. Stewart*, 833 A.2d 961, 979 (Del. Ch. 2003)) .

(n58)Footnote 56.2. *Beam*, 845 A.2d at 1051-1052 .

(n59)Footnote 57. In contrast, in the parent and wholly owned subsidiary context, there is no threat to director loyalty, as directors of the subsidiary corporation have only a duty to manage in the best interests of the parent. *See, e.g., Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 201 (Del. Ch. 2006) , *aff'd*, 931 A.2d 438 (Del. 2007) ("I take it as no novelty for me to hold that the [subsidiary] board had no duty to replicate the deliberative process of its sole stockholder's board of directors. In the absence of any indication that they would be causing [the subsidiary] to violate legal obligations owed to others, the [subsidiary] board was free to take action in aid

of its parent's business strategy."); *Grace Bros. Ltd. v. Uniholding Corp.*, CA 17612, 2000 Del. Ch. LEXIS 101, at *40 (July 12, 2000) (observing that "[i]t is by no means a novel concept of corporate law that a wholly-owned subsidiary functions to benefit its parent"); see also *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (holding that "in a parent and wholly owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders").

(n60)Footnote 58. *Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 710-11 (Del. 1983) (citation omitted); see also *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324 (Del. Ch. 1987) (applying the same standard where the director was an officer of the affiliate).

(n61)Footnote 59. See *Warshaw v. Calhoun*, 221 A.2d 487, 492 (Del. 1966) (stating that dual fiduciaries' duties are to be exercised "in light of what is best for both corporations").

(n62)Footnote 60. See *Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 710-711 (Del. 1983) .

(n63)Footnote 61. See, e.g., *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110 (Del. 1994) (holding business judgment review could never apply to a negotiated cash out merger between a controlling stockholder and its subsidiary); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) (holding business judgment review could never apply to controlling stockholder's sale of controlled corporation's stock to a second controlled corporation); cf. *In re Pure Resources Inc. S'holders Litig.*, 808 A.2d 421, 438 (Del. Ch. 2002) (holding that business judgment review could apply to controlling stockholder's noncoercive tender offer).

(n64)Footnote 62. See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 113 (Del. 1994) (stating standard, affirming Court of Chancery's finding that 43.3 percent stockholder exercised control over corporation's business).

(n65)Footnote 63. See *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531, 551 (Del. Ch. 2003) ("[T]he question of whether a large block holder has 'control' may be relevant, and intertwined with, the question of whether the merger was approved by uncoerced, independent directors acting solely to advance the interests of the corporation and its disinterested stockholders rather than supine servants of an overweening master").

(n66)Footnote 64. *Cysive*, 836 A.2d at 553 .

(n67)Footnote 65. *Cysive*, 836 A.2d at 552 (finding that 40 percent stockholder's ability to "elect a new slate [of directors] more to his liking without having to attract much, if any, support from public stockholders" supported a finding of control); see also *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 116-17 (Del. 1994) (focusing on controlling stockholders' ability to "stop dividend payments or to effect a subsequent cash out merger at a less favorable price, for which the remedy would be time consuming and costly litigation" as a means of retaliating against other stockholders), quoting *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 502. (Del. Ch. 1990) .

(n68)Footnote 66. *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002) .

(n69)Footnote 67. See *Phillips v. Insituform of N. Am., Inc.*, CA 9173, 1987 Del. Ch. LEXIS 474 (Aug. 27, 1987) (noting that "the law demands of directors ... fidelity to the corporation and all of its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them").

(n70)Footnote 68. See *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531, 536 (Del. Ch. 2003) (finding majority of independent directors had no material financial interest in continued receipt of directors' fees; nevertheless finding that the business judgment rule did not apply based on controlling stockholder status); see also *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421 at 436 n. 17 (Del. Ch. 2002) (stating that, in these circumstances, Delaware law reflects "a less trusting view of independent directors than is reflected in the important case of *Aronson v. Lewis*, which presumed that a majority of independent directors can impartially decide whether to sue a controlling stockholder"). For the materiality requirement, see § 4.04[1] above.



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Corporate Governance: Law and Practice

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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.05

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§ 4.05 Application of the Entire Fairness Standard of Review

[1] Entire Fairness Review of Board Decisions

The entire fairness standard, rather than deferential review under the business judgment rule, will be used by a court to review board decisions when a plaintiff has rebutted one of the elements of the business judgment rule.ⁿ¹ Delaware courts have "generally and consistently refrained from adopting a bright-line rule for determining when a director's breach of duty of independence through self-interest translates into evidence sufficient to rebut the business judgment presumption accorded board action."ⁿ² This case-specific determination is further complicated by the fact that, by taking certain procedural safeguards to be discussed below, directors may sometimes preserve business judgment review.ⁿ³

Entire fairness review will apply from the outset when director self-interest or lack of independence has deprived the corporation of a "neutral decision-making body."ⁿ⁴ A corporation presumptively lacks a "neutral decision-making body" where a majority of the board of directors is interested in or lacks independence regarding a given transaction.ⁿ⁵ Entire fairness review will also presumptively apply where any director is interested in a challenged transaction but fails to disclose such self-interest to the entire board when a reasonable director would have viewed the existence of the material interest as a significant fact.ⁿ⁶ And even where a majority of the board is disinterested and independent, and where there has been disclosure of any conflicts that exist, entire fairness review may still apply where a stockholder's voting power gives it the ability to control both corporate parties to a transaction and the potential exercise of that power is deemed coercive in the circumstances.ⁿ⁷ The application of entire fairness review, rather than deferential business judgment review, is often outcome-determinative.ⁿ⁸

[2] Entire Fairness Analysis

"[T]he doctrine of entire fairness does not lend itself to bright line precision or rigid doctrine."ⁿ⁹ Nevertheless, the description of the doctrine in *Weinberger v. U.O.P., Inc.* ⁿ¹⁰ remains the definitive articulation of the standard:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of

fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a non-fraudulent transaction, we recognize that price may be the preponderant consideration outweighing other features of the merger.¹¹

Courts generally have equated entire fairness with the terms of a hypothetical arm's-length transaction between two unrelated parties.¹² The use of protective devices in conflict transactions, such as a special committee of independent directors or a majority-of-the-minority voting condition, generally is viewed as evidence of fairness. The absence of these devices may or may not be regarded as evidence of unfairness.¹³ The court's "broad remedial powers" to address unfair transactions include the ability to reform a contract in order to remedy a breach of fiduciary duty,^{13.1} or to require directors to disgorge bonuses.^{13.2}

[a] Fair Dealing

In determining whether there has been "fair dealing," courts have looked at such elements as: (1) whether the corporation was financially injured by the timing of the transaction and whether the interested directors gained from the timing of what the corporation lost;¹⁴ (2) whether the transaction was structured to maximize benefits to the fiduciaries at the expense of corporate profits;¹⁵ (3) whether the transaction was negotiated by an independent committee of disinterested directors (or otherwise approved by a majority of the "disinterested members of the board") or whether procedural safeguards were in place to protect the interests of disinterested shareholders.¹⁶ The purpose of an independent negotiating structure is to replicate the result of arm's-length negotiations.¹⁷

Adequate disclosure to disinterested directors and stockholders is another factor in determining whether there has been fair dealing.¹⁸

Courts have found unfair dealing particularly in situations where the board's process was insufficient or tainted. The failure to use independent advisors and directors in negotiating an interested transaction can support a finding of unfair dealing.¹⁹ Courts also have found unfair dealing where an interested party obtained confidential information from the special committee or conspired with the special committee's advisors.²⁰

[b] Fair Price

Inquiry into fair price is complex and arises often in the context of parent-subsidary transactions, such as mergers where the dominating corporation is deemed to be on both sides of the transaction.

The "fair price" aspect of the entire fairness standard involves consideration of "all relevant factors," with a conclusion based on "proof of value by any techniques or methods which are generally considered acceptable in the financial community."²¹ Importantly, the fair price analysis under the entire fairness standard differs from the unique fair value analysis conducted by Delaware courts in examining the appraisal value of a shareholder's shares under the Delaware appraisal statute.²² Under an appraisal analysis, a Delaware court is required to "appraise the shares, determining their fair value, exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value."²³ In contrast, under an entire-fairness analysis, a court will take into account the value of "synergies" or consolidation economies resulting from the transaction.²⁴ Of course, any determination of fair price will depend on the facts underlying the given transaction or decision. In the context of self-dealing transactions, however, entire fairness is recognized as being a fair price is as close an approximation as can be judicially constructed to what the value that arm's-length bargaining might produce.²⁵

Many Delaware courts have observed that in a "non-fraudulent transaction," price may be "the preponderant consideration."ⁿ²⁶ There also is a small number of decisions applying the entire fairness standard and finding that the transactions were fair despite the presence of unfair dealing.ⁿ²⁷ Other decisions suggest, however, that unfair dealing usually prevents a finding of entire fairness because the unfair dealing adversely affects the price paid to the stockholders for their shares.ⁿ²⁸

[3] Section 144: Delaware's "Safe Harbor" Statute

At common law, a transaction in which a majority of the board was interested was voidable at the insistence of the corporation or its shareholders.ⁿ²⁹ It is unlikely that this was a rule of *per se* voidability that would be applied without regard to the fairness of a transaction.ⁿ³⁰ Section 144 of the Delaware General Corporation Law was enacted in 1967 to provide a "safe harbor" from this common law rule and establish clearly that such transactions are not void or voidable solely because of the financial interests in the transaction of officers or directors or solely because such officers or directors are present at or participate in the meeting of the board or committee that authorizes the transaction or because their votes are counted for the approval of the transaction. Section 144 operates to validate the transaction if either (i) the material facts concerning the interests of officers and directors in the transaction and as to the contract or transaction itself are disclosed to or known by the board or committee approving the transaction, which is authorized in good faith by the affirmative vote of a majority of the disinterested directors or of the shareholders; or (ii) the transaction is entirely fair to the corporation as of the time it is authorized, approved or ratified. Section 144 provides:ⁿ³¹

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

By its own terms, Section 144 applies only to self-dealing transactions where corporate directors or officers appear on both sides of a transaction or have a financial interest in a business organization that is dealing with their corporation.ⁿ³² Delaware courts have acknowledged, however, that transactions involving interested and possibly non-independent directors, but that do not involve the self-dealing that falls within the literal language of Section 144, should still be reviewed in light of the procedural protections of Section 144.ⁿ³³

[a] The Effect of Complying with the Procedural Protections of § 144

Although Section 144 of the Delaware General Corporation Law saves conflict transactions from being voidable at the insistence of the corporation or the shareholders, Section 144 does not insulate such transactions from judicial scrutiny. The plain language of Section 144 makes clear that the failure to obtain informed director or stockholder approval for a transaction will render it subject to entire fairness review under subsection Section 144(a)(3). Some cases indicate that even if a corporation complies with the "safe harbors" of Section 144(a)(1) or (a)(2), a court still may review the transaction for fairness.ⁿ³⁴ Delaware courts have distinguished between transactions involving a controlling stockholder and those that do not. When a controlling stockholder is present, compliance with Section 144(a)(1) or (2) does not result in deferential review under the business judgment rule but merely shifts the burden of proving entire fairness from the defendants to the plaintiff.ⁿ³⁵ In the absence of a controlling stockholder, compliance with Section 144(a)(1) or (2) usually will result in deferential review under the business judgment rule.ⁿ³⁶

The application of the entire fairness standard whenever a controlling stockholder is present stems from the "inherent coercion" allegedly created when a controlling stockholder stands on both sides of a transaction. This so-called "*Lynch* doctrine" originated in *Kahn v. Lynch Communications Systems, Inc.*ⁿ³⁷ where the Supreme Court of Delaware addressed a split in Chancery Court precedent regarding the effect of disinterested directors' approval upon a controlling stockholder's burden of demonstrating entire fairness. Under one line of cases, disinterested-director approval of such transactions resulted in application of business judgment review.^{n37.1} A different line of cases held that such approval merely shifted the burden of proof to the plaintiff to show that the transaction was unfair.ⁿ³⁸ The court adopted the reasoning of the former line of cases without much analysis, holding:ⁿ³⁹

The exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. However an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of the minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.ⁿ⁴⁰

As the Court of Chancery has recently explained, under the *Lynch* doctrine,

Even if an independent board attempts to wholly replicate the situation that pertains when there is no controlling stockholder by hinging the procession of the merger on: (1) the negotiation and approval of the merger by independent directors on an adversarial basis; and (2) approval by disinterested stockholders, the *Lynch* doctrine says that the entire fairness standard governs.ⁿ⁴¹

The *Lynch* doctrine will also apply where, at the time of the merger, there is no controlling stockholder, if facts show that a stockholder had controlling status during the merger negotiations.ⁿ⁴² In addition to controlling stockholder mergers, the *Lynch* doctrine has also been applied to a stock sale between two corporations dominated by a controlling stockholder.ⁿ⁴³

Despite the mandated application of entire fairness, the *Lynch* doctrine seeks to encourage the use of such procedural protections by shifting the burden of proof on the issue of fairness from the defendant to the plaintiff.ⁿ⁴⁴ A recent Court of Chancery decision has critiqued the practical value of this incentive, noting that the placement of the burden of proof under a preponderance standard is not very significant and that the very fact-intensive nature of the inquiry into whether adequate procedural protections have been employed will usually preclude a shift of the burden until after a trial has been completed.ⁿ⁴⁵ Thus, as a practical matter, a defendant litigating under the *Lynch* doctrine will often bear the burden of proving fairness throughout trial.ⁿ⁴⁶

[4] Procedures Sufficient to Change the Standard of Review or Shift the Burden of Proving Fairness

[a] Disclosure of Material Facts

For a transaction involving interested directors to benefit from procedural protections in the manner described above,ⁿ⁴⁷ there must be full disclosure of the material facts relating to the transaction, including the disclosure of any debilitating self-interest.ⁿ⁴⁸ In order for director or stockholder ratification to be effective, Section 144 requires a state of affairs in which the "material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known."ⁿ⁴⁹ Those who would rely upon disinterested director or stockholder ratification to uphold a transaction bear the burden of showing the disclosure of all material facts.ⁿ⁵⁰

Delaware decisions have focused on objective indicia of full disclosure, rather than the more subjective standard of directors' or shareholders' knowledge.ⁿ⁵¹ Because this inquiry focuses on disclosure of material facts, a relevant issue is what facts are material. The standard of materiality under Delaware law is the same as the standard under the federal securities laws:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.ⁿ⁵²

Materiality is frequently stated to be viewed from the perspective of a "reasonable investor" or "reasonable shareholder" for purposes of stockholder ratification under Section 144(a)(2), and a similar standard applies in the context of disinterested-director approval under Section 144(a)(1).ⁿ⁵³ Despite the similar framing of standards, however, what is material to a reasonable director in the fiduciary context of director decision making may be different than what is material to a reasonable stockholder evaluating a transaction.ⁿ⁵⁴ A director's financial interest in a business entity that stands on the other side of a transaction from the corporation is per se material and must be disclosed, regardless of whether it is so large as to constitute a likely influence on the particular director.ⁿ⁵⁵ This rule is consistent with the general principle that facts giving rise to any debilitating self-interest or lack of independence must be fully disclosed.ⁿ⁵⁶

[b] Disinterested-Director Approval

As discussed above, depending on the legal circumstances of the transaction, disinterested-director approval of a transaction may restore review under the business judgment rule or shift the burden to the plaintiffs to prove the transaction was unfair.ⁿ⁵⁷ A common method of securing disinterested-director approval of a challenged transaction is through the use of a special committee of disinterested and independent directors. The widespread use of special committees in interested-director transactions was prompted by a statement by the Delaware Supreme Court in *Weinberger v. U.O.P., Inc.*,ⁿ⁵⁸ which has been reiterated in subsequent decisions,ⁿ⁵⁹ that negotiation on behalf of the minority shareholders by a committee of independent directors would constitute strong evidence of the fairness of a transaction. Relatedly, the Delaware Court of Chancery has noted that the failure to utilize a committee of independent directors or other procedural safeguards "evidences the absence of fair dealing."ⁿ⁶⁰ While the formation of a special committee of independent directors is not required for effective disinterested-director approval,ⁿ⁶¹ the ability of such committees to keep otherwise compromised negotiations "at arms' length" is an important indicia of procedural fairness.ⁿ⁶²

To gain the benefits of using a special committee of disinterested directors, a transaction's proponents must prove the independence of the committee members and the thoroughness with which the committee has performed its duties.ⁿ⁶³ The special committee must have real bargaining power that it can exercise on an arm's-length basis.ⁿ⁶⁴ For example, in *Kahn v. Lynch Communications Systems, Inc.*ⁿ⁶⁵ There, Lynch shareholders challenged the merger of Lynch Communications Systems, Inc. into Alcatel U.S.A. Corp, which owned 43.3 percent of Lynch and exercised control over its operations. Although Alcatel designated only five of the eleven Lynch directors, "the non-Alcatel directors deferred to Alcatel because of its position as a significant shareholder and did not exercise their own business judgment that Alcatel's position was correct."ⁿ⁶⁶ In the past, Alcatel had demanded that the board respect its large stockholder status and had exercised influence in decisions about executive compensation and strategic transactions.ⁿ⁶⁷ Although the Lynch board formed a special committee of independent directors to negotiate the merger, the court found that the committee's decision was influenced by Alcatel's control. After rejecting three Alcatel offers as inadequate, the committee ultimately agreed to a price that its members believed was unfair in order to avoid a threatened hostile tender offer by Alcatel at an even lower price.ⁿ⁶⁸ Because the court found that the committee had surrendered to the dictated terms of the controlling shareholder, there was no valid disinterested-director approval sufficient to shift the burden of proof.ⁿ⁶⁹

A similar result was obtained in *Kahn v. Tremont Corp.*ⁿ⁷⁰ There the Delaware Supreme Court reversed the Court of Chancery finding that a special committee acted with sufficient independence and diligence to constitute an effective disinterested-director approval. The challenged transaction was a stock sale where both the seller and purchaser corporations were dominated by a controlling stockholder. The purchaser formed a special committee, consisting of three outside directors, to negotiate on its behalf. The chairman of the special committee had a long-time personal and professional relationship with an interested director, who was likely dominated by the controlling stockholder by virtue of his service as the corporation's president and CEO. The two other members of the special committee had previously been employed by the controlling stockholder. For its financial advisor, the committee chose a bank that was the current employer of the special committee's chairman and that had done substantial work for the controlling stockholder's other companies. The committee's legal advisor had also worked for the controlling stockholder's other companies, including the seller. While the committee and its advisors met four times to discuss the transaction, only the chairman was present at all four meetings. The chairman also seemed to have been the sole committee member involved in the actual negotiations over the terms of the deal.ⁿ⁷¹ Although the committee recommended the purchase, the court could not accept this as sufficiently valid disinterested-director approval. In particular, it noted that the ties between the committee, its advisors, and management and the controlling stockholder created doubts as to its true independence. Also, only one of the three committee members was adequately informed and actually engaged in the deliberative and negotiating process. Because this process did not suffice for valid disinterested-director approval, the defendants could not shift their burden under the *Lynch* doctrine.ⁿ⁷²

[c] Disinterested Stockholder Approval

As with disinterested-director approval, depending on the legal circumstances of the transaction, approval of a transaction through a vote of disinterested and informed stockholders may restore the business judgment rule or shift the burden to the plaintiffs to prove the transaction was unfair.ⁿ⁷³ At common law, majority stockholder approval of a transaction prevented it from being voidable by reason of director interest.ⁿ⁷⁴ This common law principle survived the enactment of Section 144, as evidenced by numerous decisions discussing the validating effect of stockholder ratification in general, without regard to the specific language of Section 144(a)(2).ⁿ⁷⁵

Under the common law, the validating effect of stockholder ratification only applied to votes by independent or disinterested stockholders.ⁿ⁷⁶ Although Section 144(a)(2) seems only to require a good faith approval of the stockholders entitled to vote on a transaction, the Delaware Supreme Court has required that, to be effective, such ratification must be made by a majority of disinterested stockholders entitled to vote on a transaction.ⁿ⁷⁷ This doctrine was first established in *Fliegler v. Lawrence*,ⁿ⁷⁸ which concerned the fairness of the consideration a corporation paid to purchase all the stock of a second corporation. The individual defendants were directors and officers of the purchasing

corporation, who were significant stockholders in the purchaser and owned a majority of the stock in the seller as well. Although the defendants "stood on both sides of the transaction," they argued that the entire fairness standard was inapplicable because a majority of the purchaser's stockholders ratified the purchase agreement. The court rejected this argument because most of the votes in favor of the transaction had been cast by the defendants, who were interested in the transaction. Though the defendants argued that Section 144(a)(2) does not require that ratifying stockholders be disinterested or independent, the court disagreed and placed the burden upon the defendants to show the entire fairness of the transaction.ⁿ⁷⁹ The *Fliegler* decision, read in light of the *Lynch* doctrine discussed above, indicates that, where a controlling shareholder is involved in an interested transaction, Section 144(a)(2) shareholder ratification cannot be relied upon to shift the burden of proof unless the transaction is approved by a majority of the disinterested minority stockholders.

The effect of independent stockholder ratification as it relates to alleged breaches of the duty of loyalty remains undeveloped.ⁿ⁸⁰ As noted above, stockholder approval ultimately can lead to business judgment review unless a controlling stockholder is involved in the transaction. In controlling stockholder transactions, approval by fully-informed holders of a majority of the minority shares merely shifts the burden of proving entire fairness to the plaintiff.ⁿ⁸¹ The Delaware courts have explained that a contractual provision that conditions the controlling stockholder transaction on minority stockholder approval can ameliorate the coercive influence of the controlling stockholder.ⁿ⁸² A recent Court of Chancery decision held that a majority-of-the-minority approval requirement should be conditioned on approval by a majority of the total number of outstanding minority shares entitled to vote on the transaction, rather than a majority of those minority shares actually voting on the transaction.ⁿ⁸³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Causes of Action Self-Dealing Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses Business Judgment Rule Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Loyalty

FOOTNOTES:

(n1)Footnote 1. *See* § 4.03[5][b] above; William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors*, Ch. 2 (7th ed. 2003).

(n2)Footnote 2. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1993) (recognizing, in addition, that "the question of when director self-interest [or lack of independence] translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case").

(n3)Footnote 3. *See* § 4.05[4] above.

(n4)Footnote 4. *See Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1170 (Del. 1995) ; *see also Orman v. Cullman*, 794 A.2d 5, 22 (Del. Ch. 2002) .

(n5)Footnote 5. *See Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168, 1170 n.5 (Del. 1995) ; *see also Aronson v. Lewis*, 473 A.2d 803, 815 (Del. 1988) (demand futility can be established by showing majority suffered from debilitating self-interest).

(n6)Footnote 6. *See HMG/Courtland Properties., Inc. v. Gray*, 749 A.2d 94, 113 (Del. Ch. 1999) citing *Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168 (Del. 1995) .

(n7)Footnote 7. *See* § 4.04[3][b] above; *see also In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531, 553 (Del. Ch.

2003) (holding that entire fairness review always applies to a long-form merger between companies potentially controlled by large stockholder; explaining that "controlling stockholders possess such potent retributive capacity that the entire fairness standard must apply regardless of the presence of an independent board majority, an effective special committee, and/or a majority of the minority provision"); *see also In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002) . The *Pure Resources* court, however, held that the entire fairness standard would not apply to a controlling stockholder's tender offer that was structured in such a way as to render it non-coercive. *Pure Resources*, 808 A.2d at 438 ; *see also Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 247-48 (Del. 2001) (holding that entire fairness review is not applicable to short-form controlling stockholder mergers under Section 253 of the Delaware General Corporation Law).

(n8)Footnote 8. *See, e.g., Emerald Partners v. Berlin*, 787 A.2d 85, 89 (Del. 2001) (stating that under Delaware corporate law, "[t]he applicable standard of judicial review often controls the outcome of the litigation on the merits"); *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994) (acknowledging that the different review standards are of "critical importance" to the outcome); *Orman v. Cullman*, 794 A.2d 5, 20 n. 36 (Del. Ch. 2002) (explaining that the "entire fairness" standard of review "normally will preclude dismissal of a complaint on a Rule 12(b)(6) motion to dismiss").

(n9)Footnote 9. *Nixon v. Blackwell*, 626 A.2d 1366, 1381 (Del. 1993) .

(n10)Footnote 10. *Weinberger v. U.O.P., Inc.*, 457 A.2d 701 (Del. 1983) .

(n11)Footnote 11. *Weinberger*, 457 A.2d at 711 .

(n12)Footnote 12. *See, e.g., Getty Oil v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970) .

(n13)Footnote 13. *Compare Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985) (holding that an outside fairness opinion is not required as a matter of law where directors are entitled to good faith reliance upon the accuracy of management reports); *Sealy Mattress Co. of NJ, Inc. v. Sealy, Inc.*, 532 A.2d 1324, 1336 (Del. Ch. 1987) (finding absence of procedural protections were "pertinent factors" and "highly persuasive" evidence of procedural unfairness) *with Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch. 1986) (noting that "the presence of such factors [suggesting independent negotiating structures] typically constitute indicia of fairness; their absence, however, does not itself establish any breach of duty) *and Wiegand v. Berry Petroleum Co.*, CA 9316, 1991 Del. Ch. LEXIS 37 (Mar. 27, 1991) (finding fact that controlling stockholder "furnished no procedural protections for the minority, such as independent negotiators, legal and financial advisors, or a 'majority of the minority' veto" constituted evidence of unfair dealing).

(n14)Footnote 13.1. *In re Loral Space and Communications Inc.*, Nos. 2808, 3022, 2008 WL 4293781 (Del. Ch. Sept. 19, 2008) (declining to decide whether individual directors had engaged in conduct exposing them to personal liability, because reformation was a sufficient remedy).

(n15)Footnote 13.2. *Julian v. Eastern States Const. Serv., Inc.* , No. 1892, 2008 WL 2673300 (Del. Ch. July 8, 2008) ("Self-interested directorial compensation decisions made without independent protections, like other interested transactions, are subject to entire fairness review.").

(n16)Footnote 14. *See, e.g., Kumar v. Racing Corp.*, CA 12039, 1991 Del. Ch. LEXIS 75 (Apr. 26, 1991) (finding that timing of merger in order to avoid honoring put and conversion rights of preferred stockholders supported finding of unfair dealing); *Van de Walle v. Unimation, Inc.*, CA 7046, 1991 Del. Ch. LEXIS 27 (Mar. 7, 1991) (finding timing of merger did not support unfair dealing where majority stockholder had reason to believe less valuable consideration would be available in the future and the minority was not deprived of tax savings going to majority); *Smith v. SPNV Holdings, Inc.*, CA 8395, 1989 Del. Ch. LEXIS 46 (Apr. 26, 1989) (denying plaintiff's motion for summary judgment where defendant's argument that stockholders' lost dividend was offset by time-value benefit of early receipt of merger consideration created issue of material disputed fact); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch.

1986) (holding that controlling stockholder's timing of merger for personal gain, with no corresponding benefit to corporation or stockholders, would not support finding of unfair dealing without showing of some harm to corporation).

(n17)Footnote 15. *See, e.g., Summa Corp. v. Trans World Airlines, Inc.*, 540 A.2d 403, 407 (Del. 1988) (finding parent corporation's requirement that subsidiary deal exclusively with parent, at prices causing loss to the subsidiary, and structuring lease transactions to create tax benefits to parent to the harm of the subsidiary suggested unfair dealing); *Van deWalle v. Unimation, Inc.*, CA 7046, 1991 Del. Ch. LEXIS 27 (Mar. 7, 1991) (finding majority stockholder's side deals with merger partner did not support finding of unfair dealing where side deals had valid business rationales, subjected majority stockholder to financial obligations not shared by the minority, and no facts indicated they diverted merger consideration from minority stockholders).

(n18)Footnote 16. *See, e.g., Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937-39 (Del. 1985) (finding strong evidence in support of fair dealing where majority of minority stockholders voted to approve merger agreement and board set up independent bargaining team to negotiate agreement in an adversarial manner); *Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 714 n. 7 (Del. 1983) (noting that, since "fairness in this context [of a controlling stockholder merger] can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued"); *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 504 (Del. Ch. 1990) (finding "strong evidence of fair dealing" where majority of minority stockholders approved merger, which was negotiated by an independent committee of directors and non-independent directors completely abstained from decisionmaking process); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 275 (Del. Ch. 1989) (finding evidence supported fair dealing in adoption of employee stock ownership plan that would arguably prevent hostile takeovers where employees fully funded the plan and controlled the disposition and voting of stock covered by the plan; analogizing this process to an independent board committee); *Sealy Mattress Co. of NJ, Inc. v. Sealy, Inc.*, 532 A.2d 1324, 1336 (Del. Ch. 1987) (finding board's lack of any independent directors or advisors "highly persuasive evidence" of unfair dealing).

(n19)Footnote 17. *See, e.g., Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1121 (Del. 1994) (stating that courts must scrutinize actions of purportedly independent negotiators to see if they "replicated a process 'as though each of the contending parties had in fact exerted its bargaining power at arm's length.'"), quoting *Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 709-710 n.7 (Del. 1983) .

(n20)Footnote 18. *See, e.g., Sealy Mattress Co. of NJ, Inc. v. Sealy, Inc.*, 532 A.2d 1324, 1336 (Del. Ch. 1987) (finding board's failure to make "any effort to determine whether the [merger] price was fair" and reliance on information provided by controlling stockholder supported finding of unfairness); *see also Smith v. Van Gorkom*, 488 A.2d 858, 873-78 (Del. 1985) (finding the lack of valid internal information or independent opinions supporting fairness of merger consideration supported finding that board did not validly approve merger).

(n21)Footnote 19. *See Oliver v. Boston University*, 2006 WL 1064169 (Del. Ch. Apr. 14, 2006) .

(n22)Footnote 20. *See In re Emerging Commc'ns S'holders Litig.*, 2004 WL 1305745, at *39-40 (Del. Ch. May 3, 2004) ; *Gesoff v. IIC Indus. Inc.*, 2006 WL 1458218 (Del. Ch. May 18, 2006) .

(n23)Footnote 21. *See Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 713 (Del. 1983) .

(n24)Footnote 22. *Del. Code Ann. tit. 8, § 262* (2003).

(n25)Footnote 23. *Del. Code Ann. tit. 8, § 262(h)* (2003).

(n26)Footnote 24. *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1143 (Del. Ch. 1994) , *aff'd*, 663 A.2d 1156 (Del. 1995) (stating "the components of value in an acquisition might be considered to be two: the going concern value of the firm as currently organized and managed and the 'synergistic value' to be created by the changes the bidder contemplates (e.g., new management, cost efficiencies, etc.). This second component will vary to some extent among

bidders. It is the expectation of such synergies that allows a rational bidder to pay a premium when he negotiates a transaction"); *see also* *Allied Chem. & Dye Corp. v. Steel & Tube Co.*, 122 A. 142, 144 (Del. Ch. 1923) (finding that "[t]he fair price at which assets should be sold is to be determined by considering the matter not only from the side of the seller ..., but also from the side of possible purchasers in the light of what the assets may be worth to them").

(n27)Footnote 25. *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 886-887 (Del. 1970) (equating fair price with what would obtain in an unimpaired free market), *rev'd on other grounds*, 694 A.2d 422 (Del. 1997) ; *see also* *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 118 (Del. Ch. 1999) (finding that the price paid was unfair because, among other things, "a skilled and properly motivated negotiator could have done better ... in price negotiations").

(n28)Footnote 26. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) .

(n29)Footnote 27. *See Emerald Partners v. Berlin*, 840 A.2d 641 (Del. 2003) ; *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1178 (Del. 1995) ; *Oliver v. Boston Univ.*, C.A. No. 16570, 2006 WL 1064169, at *25 (Del. Ch. Apr. 14, 2006) .

(n30)Footnote 28. *See, e.g., HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 118 (Del. Ch. 1999) .

(n31)Footnote 29. *See, e.g., Kerbs v. Cal. E. Airways*, 90 A.2d 652, 655 (Del. 1952) (holding that, although the status of a majority of directors as beneficiaries under stock option rendered it voidable, a majority of stockholders could ratify their act).

(n32)Footnote 30. *See, e.g., Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991) ("At common law, a corporation's stockholders did have the power to nullify an interested transaction, although considerations of the transaction's fairness appear to have played some part in judicial decisions applying this rule"); Rodman Ward, Jr. *et al.*, *Folk on the Delaware General Corporation Law* § 141.1 at IV-197 (4th Ed. 2003) (arguing that a per se rule did not apply at common law, as courts considered the motives of the interested directors and the effects of the transaction).

(n33)Footnote 31. *Del. Code Ann. tit. 8, § 144* (2003).

(n34)Footnote 32. The statute applies to any "contract or transaction [1] between a corporation and 1 or more of its directors or officers, or [2] between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest." *Del. Code Ann. tit. 8, § 144* (2003); *see also*, *Cooke v. Oolie*, CA 11134, 1997 Del. Ch. LEXIS 92 , at * 32-40 (June 23, 1997) (applying Section 144 to classic self-dealing transaction in which directors lent money to their corporation); *cf.* *Cooke v. Oolie*, CA 11134, 2000 Del. Ch. LEXIS 89, at *44, 45 n.39 (May 24, 2000) (holding Section 144 did not apply where directors' status as creditors created material financial interest in the transaction divergent from that of stockholders).

(n35)Footnote 33. *See Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1169-1170 (Del. 1995) (approving of Court of Chancery's analysis to uphold transaction outside literal language of statute where interested director made full disclosure and decision was ratified by independent majority of the board); *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 112-113 (Del. Ch. 1999) (explaining that precedent and the "desirability of doctrinal and statutory coherence" suggest transactions outside the literal language of Section 144 should be viewed in light of its statutory policies and procedures); *accord Oberly v. Kirby*, 592 A.2d 445, 467 (Del. 1991) (applying procedures of statutory safe harbor in allowing independent directors to ratify interested transaction of non-stock charitable corporation).

(n36)Footnote 34. *See Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 74 (Cal. Dist. Ct. App. 1952) (stating that "[e]ven though the [disinterested ratification] requirements of [a similar statute] are technically met, transactions that are unfair and unreasonable to the corporation may be avoided"); *Aronoff v. Albanese*, 446 N.Y.S.2d 368, 371 (App. Div. 1982) (holding that ratification under statute similar to Section 144 shifts burden of proof on the

issue of fairness, but does not validate transaction); *Scott v. Multi--Amp Corp.*, 386 F. Supp. 44, 68 (D.N.J. 1974) (stating, notwithstanding the disjunctive framing of a similar statute, there is "nothing in the [statute] to suggest that the legislature intended it to alter the traditional doctrine that a fiduciary who engages in self-dealing must endure the burden of proving that a challenged transaction is fair and equitable).

(n37)Footnote 35. See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 117 (Del. 1994) (holding, in the context of a negotiated controlling stockholder merger, that compliance with Section 144(a)(1) and/or 144(a)(2) merely shifts the burden on the issue of fairness, and does not restore the protections of the business judgment rule); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1154 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995) (citing *Lynch* for the proposition that "compliance with the terms of Section 144 does not restore to the board the presumption of the business judgment rule; it simply shifts the burden to plaintiff to prove unfairness"); *Citron v. E. I. DuPont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990) (finding that approval of a cash-out merger by the disinterested directors or a majority of the minority shareholders results in burden-shifting rather than the application of the business judgment rule and stating that "shareholder ratification and disinterested director intervention have a different procedural effect where the transaction is a parent-subsidary merger, than in the cases where the transaction is with a fiduciary that does not control the corporation"); *but see* Steven M. Haas, *Toward a Controlling Shareholder Safe Harbor*, 90 Va. L. Rev. 2245 (2004).

(n38)Footnote 36. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 365-66 (Del. 1993) (construing Section 144 as to allow "three alternative methods permit[ing] an otherwise interested transaction to be brought within the protection of the business judgment rule"); *Cooke v. Oolie*, CA 11134, 2000 Del. Ch. LEXIS 89, at **44-45 (May 24, 2000) (explaining that business judgment review should apply where a minority of the board's interest in the transaction is disclosed and ratified by a disinterested majority of directors); *Nebenzahl v. Miller*, CA 13206, 1996 Del. Ch. LEXIS 113, at *12 (Aug. 26, 1996) ("It certainly seems unlikely the General Assembly intended the same Director Defendants, who have made full disclosure and whose contemplated transaction has received the blessings of a majority of disinterested directors and a majority of the shareholders, to defend against a claim that the transaction was nonetheless unfair"); *Kaplan v. Goldsamt*, 380 A.2d 556 (Del. Ch. 1977) (holding that board's decision to have corporation purchase stock from director would be reviewed under the business judgment rule, absent a showing of waste); *Alcott v. Hyman*, 208 A.2d 501, 507 (Del. 1965) ("In the absence of stockholder ratification, the burden of the defendants is to show to the court's satisfaction, in the exercise of its own judgment after a close scrutiny of the transaction, that the directors in fact acted in utmost good faith and exercised scrupulous fairness. Given such stockholder ratification, however, the defendants' burden is reduced to that of showing that the terms were not so unbalanced as to amount to waste or that the question is such a close one factually as to fall within the realm of the exercise of sound business judgment"); *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 91 A.2d 57 (Del. 1952), *rev'd and remanded*, 92 A.2d 594 (Del. 1952) (holding that the business judgment rule would apply to directors' decision to award themselves stock options, wherein the directors "represented both themselves and the corporation," so long as there was stockholder ratification).

(n39)Footnote 37. *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110 (Del. 1994) .

(n40)Footnote 37.1. See *in re Trans World Airlines, Inc. S'holders Litig.*, 1988 WC 111271 (Del. Ch. Oct. 21, 1988); *Puma v. Marriott*, 283 A.2d 693. (Del. Ch. 1971) .

(n41)Footnote 38. See *Lynch*, 638 A.2d at 1115-1116 (citing cases).

(n42)Footnote 39. In stating the "policy rationale" for an exceptionless rule that entire fairness review be applied, the court simply quoted at length from a case that emphasized a controlling stockholder's "potential to influence, however subtly, the vote of ratifying minority stockholders" by possibly taking future retributive actions against stockholders. See *Lynch*, 638 A.2d at 1115-1116, quoting *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990) . Regardless of the accuracy of this observation, it fails to address the deference normally given to decisions of putatively independent directors, which is in large part the subject of this chapter.

(n43)Footnote 40. See *Lynch*, 638 A.2d at 1117 (citations omitted).

(n44)Footnote 41. *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531, 548 (Del. Ch. 2003) ; see also *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) (explaining that "the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny").

(n45)Footnote 42. See *Emerald Partners v. Berlin*, 726 A.2d 1215 (Del. 1999) ; see also *Orman v. Cullman*, 794 A.2d 5, 20-21 n.34 (Del. Ch. 2002) (interpreting the *Emerald Partners* decision).

(n46)Footnote 43. See *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) ; cf. *In re Wheelabrator Tech., Inc.*, 663 A.2d 1194, 1205 (Del. Ch. 1995) (holding the *Lynch* doctrine inapplicable to merger with 22 percent, non-controlling stockholder).

(n47)Footnote 44. See *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531, 548 (Del. Ch. 2003) .

(n48)Footnote 45. *Cysive*, 836 A.2d at 549 .

(n49)Footnote 46. See *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005) .

(n50)Footnote 47. The precise benefits are that (1) the transaction will not be voidable under the common law rule, and either (a) it will be reviewed under the deferential business judgment rule (most cases), or (b) enjoy a shift in the burden of proof under the *Lynch* doctrine. See § 4.05[3][a] above.

(n51)Footnote 48. See *Del. Code Ann. tit. 8, § 144(a)(1) and (2)* (2003).

(n52)Footnote 49. See *Del. Code Ann. tit. 8, § 144(a)(1) and (2)* (2003).

(n53)Footnote 50. See, e.g., *Yiannatsis v. Stephanis by Sterianou*, 653 A.2d 275, 280 (Del. 1995) , quoting Folk on the Delaware General Corporation Law § 144.5.2.3 (1992); *Solomon v. Armstrong*, 747 A.2d 1098, 1117 n. 58 (Del. Ch. 1999) ("the party offering the defense of shareholder ratification bears the burden of proof of showing that the disclosure was legally sufficient").

(n54)Footnote 51. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168 (Del. 1995) (holding that effective ratification, permitting review under the business judgment rule, was not possible where an "interested director fail[ed] to disclose his interest") (emphasis in original); see also *Cooke v. Oolie*, CA 11134, 2000 Del. Ch. LEXIS 89, at *44 (May 24, 2000) (explaining that ratification under Section 144 is possible "if the interested director fully discloses his interest.")

(n55)Footnote 52. See *Rosenblatt v. Getty Oil. Co.*, 493 A.2d 929, 944 (Del. 1985) , quoting *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) .

(n56)Footnote 53. See *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 113 (Del. Ch. 1999) (stating that the test is whether " 'a reasonable director would have regarded the existence of the [fact] as a significant fact in the evaluation of the proposed transaction' "), quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168 (Del. 1995) .

(n57)Footnote 54. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 258 n. 49 (Del. 2000) .

(n58)Footnote 55. See *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 113-14 (Del. Ch. 1999) .

(n59)Footnote 56. *Del. Code Ann. tit. 8, § 144(a)(1) and (2)* (2003).

(n60)Footnote 57. See § 4.05[3][a] above .

(n61)Footnote 58. *Weinberger v. U.O.P., Inc.*, 457 A.2d 701 (Del. 1983) .

(n62)Footnote 59. *See, e.g., Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 938 n.7 (Del. 1985) .

(n63)Footnote 60. *Seagraves v. Urstadt Property Co.*, CA 10307, 1996 Del. Ch. LEXIS 36, at *16 (Apr. 1, 1996) .

(n64)Footnote 61. *See, e.g., Solomon v. Armstrong*, 747 A.2d 1098, 1113 n. 38 (Del. Ch. 1999) (explaining, "Use of a special committee of directors as a device to ensure fairness is not the exclusive strategy a board can use, however. Where a fair process is the goal, *any strategy* that successfully protects minority interests will suffice")(emphasis in original); *see also Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 846 (Del. 1987) ; *Rand v. W. Airlines, Inc.*, CA 8632, 1994 Del. Ch. LEXIS 26 (Feb. 25, 1994) , *aff'd*, 659 A.2d 228 (Del. 1995) ; *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch. 1986) .

(n65)Footnote 62. *See Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 709 n. 7 (Del. 1983)

(n66)Footnote 63. *See Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1117-18 (Del. 1994) .

(n67)Footnote 64. *Lynch*, 638 A.2d at 1118 , 1120.

(n68)Footnote 65. *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110 (Del. 1994) .

(n69)Footnote 66. *Lynch*, 638 A.2d at 1115 .

(n70)Footnote 67. *Lynch*, 638 A.2d at 1114-1115 .

(n71)Footnote 68. *Lynch*, 638 A.2d at 1118-1120 .

(n72)Footnote 69. *Lynch*, 638 A.2d at 1121 .

(n73)Footnote 70. *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997)

(n74)Footnote 71. *Tremont*, 694 A.2d at 426-427 .

(n75)Footnote 72. *Tremont*, 694 A.2d at 429-430 .

(n76)Footnote 73. *See § 4.05[3][a] above.*

(n77)Footnote 74. *See, e.g., Gottlieb v. Heyden Chemical Corp.*, 91 A.2d 57, 59 (Del. 1952) ("the entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully informed stockholders"); *Kerbs v. Cal. E. Airways*, 90 A.2d 652, 655 (Del. 1952) (citing cases for the proposition that stockholder ratification "cures any voidable defect in the action of the Board").

(n78)Footnote 75. *See, e.g., Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979) (applying common law ratification rule to grant of stock options to key employees, including some directors, without regard to Section 144(a)(2)); *Lewis v. Vogelstein*, 699 A.2d 327, 334-36 (Del. Ch. 1997) (discussing stockholder ratification under the common law generally, noting only that Section 144(a)(2) may "bear on the effect" of such principles).

(n79)Footnote 76. *See, e.g., Lewis v. Hat Corp. of America*, 150 A.2d 750 (Del. Ch. 1959) (upholding transaction that was ratified by a majority of disinterested stockholders); *see also Schiff v. RKO Pictures Corp.*, 104 A.2d 267, 271 (Del. Ch. 1954) (applying common law rule that "independent majority stockholder approval has the effect of shifting that burden back to the plaintiffs").

(n80)Footnote 77. *See, e.g., Williams v. Geier*, 671 A.2d 1368, 1381 (Del. 1996) (contrasting the disinterestedness requirement under Section 144(a)(2) with other sections counting the vote of interested stockholders).

(n81)Footnote 78. *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976) .

(n82)Footnote 79. *Fliegler*, 361 A.2d at 221-222 .

(n83)Footnote 80. See *Solomon v. Armstrong*, 747 A.2d 1098, 1114 ;17 (Del. Ch. 1999); see also *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007) ("The mere approval by Stockholders of a request by directors to take action within broad parameters does not consulate all future action within those parameters from attack.").

(n84)Footnote 81. *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1115-16 (Del. 1994) ; *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421, 430 (Del. Ch. 2002) .

(n85)Footnote 82. See *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005) .

(n86)Footnote 83. See *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *14-15 (Del. Ch. Aug. 18, 2006) . *Sample v. Morgan*, 914 A.2d 647, 664 (Del. Ch. 2007) ; *In re Lear Corp.*, 926 A.2d 94, 114-115 (Del. Ch. 2007) . Commentary has suggests that proper minority stockholder and independent director approval should result in business judgment review of the transaction, but the Delaware Supreme Court has not yet adopted this view. See, e.g., *Cox Communications*, 879 A.2d at 642-48 ; Peter V. Letsou & Steven M. Haas, *The Dilemma That Should Never Have Been: Minority Freeze Outs in Delaware*, 61 *Bus. Law.* 25 (2005).



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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.06

AUTHOR: J. Travis Laster

§ 4.06 The Appraisal Remedy and Cash-Out Mergers--*Weinberger v. UOP, Inc.*

In *Weinberger v. U.O.P., Inc.*, n1 a former shareholder of UOP challenged a cash-out merger between UOP and its majority shareholder, Signal Companies, Inc. Prior to the merger, Signal owned 50.5 percent of the stock of UOP. Seeking an investment for its excess cash, Signal arranged for two officers of Signal who were also directors of UOP to conduct an internal feasibility study. The study showed that it would be a good investment for Signal to acquire the remaining shares of UOP for up to \$24.00 per share. The market prices at the time was \$14.50 per share. Signal proposed a cash-out price of \$20 to \$21 per share and retained an investment banker, which rendered an opinion that a price in the \$20 to \$21 range was fair to the minority shareholders. The disinterested directors and a majority of the minority shareholders of UOP approved a cash-out merger at \$21 per share.

The plaintiff claimed that the merger price was unfair and that Signal and the UOP board had breached their fiduciary duties to the minority shareholders of UOP. The Court of Chancery entered judgment for the defendant, finding that there were no material misstatements or omissions in the proxy statement and the cash-out price was entirely fair. The Delaware Supreme Court reversed, holding that the cash-out merger failed to satisfy any reasonable concept of fair dealing. The Delaware Supreme Court focused on the feasibility study that concluded that it would be beneficial for Signal to acquire the UOP shares at a price of up to \$24.00, which had been prepared by officers of Signal who were also directors of UOP and had not been disclosed either to the outside directors of UOP or to the UOP minority shareholders. The court discussed the fiduciary duties of dual directors and noted that the transaction had been initiated by Signal, was presented to and approved by the UOP board within four business days, proceeded without arm's-length negotiations, and the outside directors and UOP minority shareholders had not been given material information. The court affirmed that the minority shareholder had the burden to demonstrate some unfairness before the majority shareholder would be required to show fairness and further held that, where the merger had been approved by a fully informed vote of a majority of the minority shareholders, the burden would shift to the plaintiff to prove that the transaction was unfair. However, the court also determined that the burden of proof would remain on the majority shareholder to show that all material facts had been disclosed to the minority shareholders.

In the course of its analysis of the transaction, the *Weinberger* court held that the appraisal remedy "shall govern the financial remedy available to minority shareholders in a cash-out merger."n2 The court cautioned, however, that where "fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are

involved," the appraisal remedy may be inadequate.ⁿ³ The court's holding in *Weinberger* led to a short-lived rule that, in the absence of fraud, misrepresentation, or other indications of unfair dealing, the appraisal remedy would be the sole remedy for minority shareholders in a cash-out merger.ⁿ⁴

Nevertheless, in the first post-*Weinberger* cash-out merger case it reviewed, the Delaware Supreme Court held that appraisal proceedings are not the exclusive remedy for an allegedly unfair price in a cash-out merger, even in the absence of fraud.ⁿ⁵ The court in *Rabkin v. Philip A. Hunt Chem. Corp.*,ⁿ⁶ refused to interpret *Weinberger* as holding that, absent evidence of unfair dealing, a minority shareholder's sole remedy in a cash-out merger is appraisal.ⁿ⁷ The *Rabkin* court instead interpreted *Weinberger* narrowly, holding that appraisal is the exclusive remedy only where the plaintiff attacks "judgmental factors of valuation," such as methodology used in calculating a fair price, rather than specific allegations of procedural unfairness or unfair dealing.ⁿ⁸ As the Delaware Supreme Court noted in *Glassman v. Unocal Exploration Corp.*,ⁿ⁹ this interpretation of *Weinberger* effectively eliminated the rule that appraisal is the exclusive remedy in a long-form merger.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Causes of Action Self-Dealing Business & Corporate Law Corporations Shareholders Appraisal & Dissent Rights Remedies Mergers & Acquisitions Law Mergers Duties & Liabilities of Directors & Officers Mergers & Acquisitions Law Mergers Duties & Liabilities of Shareholders Mergers & Acquisitions Law Mergers Rights of Dissenting Shareholders

FOOTNOTES:

(n1)Footnote 1. *Weinberger v. U.O.P., Inc.*, 457 A.2d 701 (Del. 1983) .

(n2)Footnote 2. *Weinberger*, 457 A.2d at 715 .

(n3)Footnote 3. *Weinberger*, 457 A.2d at 711 , 714.

(n4)Footnote 4. *See* Van deWalle v. Unimation, Inc., No. 7046, 1983 Del. Ch. LEXIS 573 (Feb. 14, 1983) (refusing to preliminarily enjoin cash-out merger at allegedly inadequate price where plaintiff would have an adequate post-merger appraisal remedy); Wilen v. Pollution Control Indus., Inc., Consol. CA 7254, 1984 Del. Ch. LEXIS 574 (Oct. 15, 1984) (dismissing complaint challenging fairness of merger where appraisal was adequate remedy and plaintiff failed to adequately plead fraud, overreaching, or breach of duty of disclosure); Patents Mgmt. Corp. v. O'Connor, CA 7110, 1985 Del. Ch. LEXIS 454 (June 10, 1985) (dismissing complaint challenging merger where appraisal could adequately address unfair price and unfair dealing claims); *Weinberger v. Palm Beach, Inc.*, CA 7696, 1985 Del. Ch. LEXIS 478 (Mar. 8, 1985) (dismissing complaint challenging leveraged buyout where plaintiff failed to adequately plead fraud or other facts indicating stockholders would be misled into foregoing their appraisal remedy); *Shapiro v. Pabst Brewing Co.*, No. 7339, 1985 Del. Ch. LEXIS 496 (July 30, 1985) (dismissing complaint alleging that manipulation of tender offer process before merger resulted in unfair price, because appraisal was exclusive remedy).

(n5)Footnote 5. *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985) .

(n6)Footnote 6. *Rabkin*, 498 A.2d 1099 .

(n7)Footnote 7. *Rabkin*, 498 A.2d at 1104 .

(n8)Footnote 8. *Rabkin*, 498 A.2d at 1100 , 1105.

(n9)Footnote 9. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 247 (Del. 2001) .



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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

*1-4 Corporate Governance: Law and Practice § 4.07***AUTHOR:** J. Travis Laster**§ 4.07 Review of Director Decisions in the Short-Form Merger Context**

In contrast to entire fairness review of director decisions in long-form mergers with controlling stockholders, Delaware has adopted a policy of non-review for transactions in which the controlling stockholder unilaterally announces a tender offer or exchange offer with the goal of increasing its ownership level in the subsidiary above 90 percent. If the offer is successful, the parent effects a short-form merger under Section 253 to eliminate the remaining public shareholders. In *In re Siliconix Inc. Shareholders Litigation*,ⁿ¹ the Court of Chancery confirmed that a parent has no obligation to offer a fair price in a tender or exchange offer. In *Glassman v. Unocal Exploration Corp.*,ⁿ² the Delaware Supreme Court held that the exclusive remedy for minority shareholders following a short-form merger is an appraisal. A two-step transaction in which a parent unilaterally makes a tender offer or exchange offer followed by a short-form merger thus arguably does not trigger fairness review at either stage.ⁿ³ The fiduciary duty of disclosure, however, continues to apply, and in *Berger v. Pubco Corp.*,^{n3.1} the Court of Chancery concluded that the controlling stockholder had violated its fiduciary duty of disclosure by failing to disclose the method by which it had calculated the cash-out price. The company argued that since it had no obligation to set a fair price, the methodology was irrelevant, but the court disagreed, concluding that shareholders were entitled to know "in a broad sense what the process was, assuming [the parent corporation] followed a process at all and did not simply choose a number randomly."^{n3.2} The court held that the shareholders were entitled to a "quasi-appraisal" remedy for this breach of fiduciary duty.

In *In re Pure Resources, Inc. Shareholders Litigation*,ⁿ⁴ the Court of Chancery elaborated on two-step transactions initiated by controlling stockholders. The court advised that a tender offer following by a short-form merger will not be subject to entire fairness review if (1) the tender offer includes a non-waivable majority of the minority stockholder tender condition, (2) the controlling stockholder promises to commence a short-form merger promptly and at the same price as the tender offer consideration if the controlling stockholder acquires 90% or more of the company's outstanding shares, and (3) the controlling stockholder does not otherwise make any retributive threats.ⁿ⁵ Directors, however, remain subject to their fiduciary duties in responding to the controlling stockholder's two-step proposal.ⁿ⁶

The *Siliconix* line of cases raises a number of issues for boards and their advisors. Most obviously, there is an apparent distinction between two-step transactions effected pursuant to a merger agreement and two-step transactions effected unilaterally by a controlling shareholder. This creates a disincentive for parent corporations to negotiate and enter into merger agreements with subsidiaries and, accordingly, undermines the utility of the special committee process. These

results raise significant policy considerations. The Delaware Supreme Court has not yet weighed in on these issues and may be influenced by broader policy concerns. It is not clear to what extent negotiations with the subsidiary or the endorsement of a transaction by the subsidiary's board, albeit short of entering into a merger agreement, would affect the analysis and create a fairness obligation.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses General Overview Mergers & Acquisitions Law Mergers Duties & Liabilities of Directors & Officers Mergers & Acquisitions Law Mergers Duties & Liabilities of Shareholders Mergers & Acquisitions Law Mergers Rights of Dissenting Shareholders Mergers & Acquisitions Law Mergers Short-Form Mergers

FOOTNOTES:

(n1)Footnote 1. *In re Siliconix Inc. S'holders Litig.*, Consol. CA 18700, 2001 Del. Ch. LEXIS 83 (June 19, 2001) .

(n2)Footnote 2. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001) .

(n3)Footnote 3. *See Siliconix*, 2001 Del. Ch. LEXIS 83 ; *In re Aquila Inc., S'holders Litig.*, 805 A.2d 184 (Del. Ch. 2002) ; *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002) ; *Next Level Communications, Inc. v. Motorola, Inc.*, 834 A.2d 828 (Del. Ch. 2003) For preferred stockholders, the consideration available in a merger often will be set by the terms of the certificate of designations that governs their shares. *See In re Appraisal of Metromedia Intern. Group, Inc.*, No. 3351, 2009 WL 1110663 (Del. Ch. April 16, 2009).

(n4)Footnote 3.1. No. 3414, 2008 WL 2224107 (Del.Ch. May 30, 2008).

(n5)Footnote 3.2. *Berger v. Pubco Corp.*, No. 3414, 2008 WL 2224107 (Del.Ch. May 30, 2008) ("In a section 253 merger, the parent need not set] up negotiating committees, hire independent financial and legal experts, etc. because it need not establish entire fairness. Nevertheless, the minority shareholders of an unregistered, non-reporting company are entitled to know at least whether the parent did or did not use such methods when setting the merger consideration, because such a fact would have assumed actual significance in the deliberations of the reasonable shareholder faced with the decision of whether or not to trust and accept the price offered by the parent.") (internal citations and quotations omitted).

(n6)Footnote 4. 808 A.2d 421 (Del. Ch. 2002) .

(n7)Footnote 5. *See id. at 445* .

(n8)Footnote 6. *See id. at 441* ("It therefore is by no means obvious that simply because a controlling stockholder proceeds by way of a tender offer that either it or the target's directors fall outside the constraints of fiduciary duty law.").



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CHAPTER 4 LEGAL DUTIES AND RESPONSIBILITIES OF THE BOARD

1-4 Corporate Governance: Law and Practice § 4.08

AUTHOR: J. Travis Laster

§ 4.08 Interested-Director Transactions in Other States

Virtually every state has adopted a statute governing conflict of interest transactions. Although the statutes typically contain certain similarities, there are also significant variations. The general purpose of the conflict of interest statutes is to relax the common law rule that conflict of interest transactions were voidable and to establish that interested transactions will not be voidable solely as a result of a director's interest in the transaction, provided certain statutory requirements are met.

As is the case in Delaware, the statutes generally do not set forth the effect of disinterested director or shareholder approval, so the effect of such approval is unclear.ⁿ¹ As a result, courts have struggled to determine whether disinterested director or shareholder approval shifts the burden to the plaintiffs to prove unfairness or if such approval insulates the transaction from further review.ⁿ²

The Model Business Corporation Act was amended in 1988 to provide a comprehensive treatment of conflict of interest transactions and, perhaps, some enhanced predictability.ⁿ³ The Model Business Corporation Act specifically defines a conflict of interest transaction,ⁿ⁴ and also spells out in some detail the steps required for effective shareholder or director approval.ⁿ⁵ Under the Model Business Corporation Act, compliance with the detailed disinterested director or disinterested shareholder approval sections is intended to insulate the transaction from judicial review based on a conflict of interest claim.ⁿ⁶ A number of states have adopted the Model Business Corporation Act.ⁿ⁷

Florida's statutory provision regarding conflict of interest transactions closely resembles Section 8.31 of the 1984 version of the Model Business Corporation Act.ⁿ⁸ Section 607.0832 provides a safe harbor for interested-director transactions if the director discloses the fact of the existence of the conflict and the transaction is approved by a majority of the disinterested directors or shareholders, or if the transaction is fair to the corporation. Despite the disjunctive language of the statute, cases and commentators have found that Section 607.0832 should be read to require a determination of fairness in all interested-director transactions.ⁿ⁹

California's statutory provision expressly requires a fairness test if an interested transaction is approved by the directors of the corporation.ⁿ¹⁰ The California statute also contains a provision that, if an interested transaction does not receive approval from disinterested directors or disinterested shareholders, then the "person asserting the validity of the contract

or transaction sustains the burden of proving that the contract or transaction was just and reasonable as to the corporation at the time it was authorized, approved or ratified."¹¹ This provision has been interpreted to mean that if disinterested-director approval is obtained, the burden does not remain on the transaction's proponent, but shifts to the transaction's challenger to prove the unfairness of the transaction.¹²

Under New York law, a fairness review is always required in connection with an interested transaction.¹³ Disinterested board or shareholder approval makes the objecting shareholders' burden more difficult since such approval shifts the burden of proof to the challengers of the transaction, but compliance with *Section 713 of the New York Business Corporation Law* does not automatically validate a transaction or remove it from entire fairness review.¹⁴

In the cash-out merger context, some states have applied the entire fairness doctrine, while others have limited the minority shareholder to the appraisal remedy in the absence of fraud.¹⁵ The North Carolina statute provides that a dissenting shareholder cannot challenge a merger "unless the action is unlawful or fraudulent" to the shareholders or the corporation.¹⁶ In *Werner v. Alexander*,¹⁷ minority shareholders challenged a cash-out merger claiming that the defendants had engaged in a course of conduct designed to reduce the value of their shares. The Court of Appeals of North Carolina held that the shareholder's claim was one for unfair price which would not support a claim of fraud.

In *Kreiger v. Gast*,¹⁸ the United States District Court for the Western District of Michigan, applying Michigan law, held that the Michigan courts would not apply the entire fairness test in addition to statutory appraisal, stating that "appraisal is the sole remedy available to a minority shareholder, even in a conflict transaction, so long as the shareholder's complaint is that he was paid less than the fair value of his shares."¹⁹

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Causes of Action Self-Dealing Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Loyalty Business & Corporate Law Corporations Shareholders Appraisal & Dissent Rights General Overview Mergers & Acquisitions Law Mergers Duties & Liabilities of Directors & Officers

FOOTNOTES:

(n1)Footnote 1. Some statutes expressly require fairness if disinterested directors approve the transaction, but not if disinterested shareholders approve the transaction. *See, e.g., Alaska Stat. § 10.06.478; Cal. Corp. Code § 310.* Other statutes expressly require a fairness test without regard to approval by disinterested directors or shareholders, but provide that the burden of proof shifts if such approval is obtained. *See, e.g., S.C. Code Ann. § 38-8-310(a).*

(n2)Footnote 2. *See Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. Ct. App. 1952); Aronoff v. Albanese, 446 N.Y.S.2d 368 (App. Div. 1982); Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974); see also, Weatherhead v. Griffin, 851 P.2d 993 (Idaho Ct. App. 1992) (finding that the Idaho statute "does not provide a basis for validating for all purposes a transaction between an interested director and the corporation whenever the technical requirements of one of the subsections have been complied with").*

(n3)Footnote 3. Model Bus. Corp. Act §§ 8.60-8.63.

(n4)Footnote 4. Model Bus Corp Act § 8.60.

(n5)Footnote 5. Model Bus. Corp. Act §§ 8.62-8.63.

(n6)Footnote 6. Model Bus. Corp. Act § 8.61.

(n7)Footnote 7. *See, e.g., Ala. Code §§ 10-2B-8.60 to 10-2B-8.63; Ariz. Rev. Stat. Ann. §§ 10-8.60 to 10-8.63; Ga. Code Ann. §§ 14-2-860 to 14-2-863; Vt. Stat. Ann. tit. 11A, § 8.60.*

(n8)Footnote 8. Florida Business Corporation Act, F.S. § 607.0832. The 1984 version of the Model Business Corporation Act is similar to Section 144 of the Delaware General Corporation Law.

(n9)Footnote 9. *See Sunrise Island, Ltd. v. Goldman Sachs & Co., 203 B.R. 171 (Bankr. N.D. Okla. 1996)* (interpreting Florida Business Corporation Act, F.S. § 607.0832); Stuart R. Cohn and Stuart B. Ames, Author's Note, *Florida Business Laws Annotated* 117 (1997) (suggesting that the statute does not automatically validate all transactions that come within its terms and a fairness review is relevant even if approval of disinterested shareholders or directors is obtained).

(n10)Footnote 10. *Cal. Corp. Code § 310.*

(n11)Footnote 11. *Cal. Corp. Code § 310(a)(3).*

(n12)Footnote 12. *See Sammis v. Stafford, 48 Cal. App. 4th 1935, 56 Cal. Rptr. 2d 589 (Ct. App. 1996).*

(n13)Footnote 13. *See Aronoff v. Albanese, 446 N.Y.S.2d 368 (App. Div. 1982).*

(n14)Footnote 14. *See Aronoff, 446 N.Y.S.2d at 371.*

(n15)Footnote 15. *See, e.g., In re Jones & Laughlin Steel Corp., 412 A.2d 1099, 1104 (Pa. 1980)* (holding that appraisal is a shareholder's exclusive post-merger remedy under Pennsylvania law); *Yanow v. Teal Indus., Inc., 422 A.2d 311 (Conn. 1979)* (holding that appraisal is the exclusive remedy in a short-form merger under Connecticut law); *Flum Partners v. Child World Inc., 557 F. Supp. 492, 500 (S.D.N.Y. 1983)* (applying Massachusetts law and holding that appraisal is the exclusive means by which a shareholder could challenge the adequacy of price); *but see, Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105 (D.R.I. 1990)* (applying Rhode Island law and holding that appraisal is not the exclusive remedy when a shareholder makes specific allegations of fraud and self-dealing); *Kademian v. Ladish Co., 792 F.2d 614, 629-630 (7th Cir. 1986)* (holding that the Wisconsin appraisal statute does not bar a breach of fiduciary duty claim); *Coggins v. New England Patriots Football Club, 492 N.E.2d 1112, 1118 (Mass. 1986)* (holding that shareholders are not limited to appraisal where violations of fiduciary duties are found); *Shidler v. All Am. Life & Fin. Corp., 775 F.2d 917 (8th Cir. 1985)* (applying Iowa law and determining that appraisal is not the exclusive remedy for minority shareholders when a merger is challenged as unlawful).

(n16)Footnote 16. *See N.C. Gen. Stat § 55-13-02(b).*

(n17)Footnote 17. *Werner v. Alexander, 502 S.E. 2d 897 (N.C. Ct. App. 1998).*

(n18)Footnote 18. *Krieger v. Gast, 179 F. Supp. 2d 762 (W.D. Mich. 2001).*

(n19)Footnote 19. *Kreiger, 179 F. Supp. 2d at 777.*



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CHAPTER 5 LIABILITY OF OFFICERS AND DIRECTORS; STATUTORY LIMITATIONS, INDEMNIFICATION
AND D&O INSURANCE

1-5 Corporate Governance: Law and Practice 5.syn

AUTHOR: Gillian McPhee

**§ 5.syn Synopsis to Chapter 5: LIABILITY OF OFFICERS AND DIRECTORS; STATUTORY LIMITATIONS,
INDEMNIFICATION AND D&O INSURANCE**

§ 5.01 Limitations on Liability of Officers and Directors: Introduction

§ 5.02 Exculpation under Section 102(b)(7) of the Delaware General Corporation Law

[1] The Genesis of Exculpatory Charter Provisions

[2] Extent of Limitations on Liability

[3] Procedural Aspects of Invoking Section 102(b)(7)

§ 5.03 Indemnification

[1] Introduction and Background

[2] Who Is Eligible for Indemnification

[3] Mandatory Indemnification

[4] Permissive Indemnification and the Statutory Standard of Conduct

[5] Advancement of Expenses

[6] Sarbanes-Oxley Act Loan Prohibition

[7] Statutory Nonexclusivity Provisions

[8] Charter and Bylaw Provisions

- [9] Indemnification Agreements
- [10] Alternative Funding Mechanisms
- [11] Indemnification in the Private Equity Context
 - § 5.04 D&O Insurance
 - [1] Corporate Governance and the D&O Insurance Marketplace
 - [2] The Role of Insurance
 - [3] Important Features of Insurance Coverage
 - [a] Structure of a Typical Policy
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 - [d] Losses
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 - [4] Common Coverage Exclusions
 - [a] Categories of Exclusions
 - [b] Conduct of the Insured
 - [c] Matters Covered Under Other Insurance Policies
 - [d] Insured versus Insured Exclusion
 - [5] Severability and Rescission
 - [6] Entity Coverage
 - [7] Supplemental Coverage

Gillian McPhee n*

FOOTNOTES:

(n1)Footnote *. The author would like to thank Jennifer L. Boatwright for her assistance in updating this chapter.



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CHAPTER 5 LIABILITY OF OFFICERS AND DIRECTORS; STATUTORY LIMITATIONS, INDEMNIFICATION
AND D&O INSURANCE

1-5 Corporate Governance: Law and Practice § 5.01

AUTHOR: Gillian McPhee

§ 5.01 Limitations on Liability of Officers and Directors: Introduction

In the wake of an unprecedented wave of corporate scandals that began with the collapse of Enron Corp., and the passage of the Sarbanes-Oxley Act of 2002ⁿ¹ (the "Sarbanes-Oxley Act" or "Sarbanes-Oxley"), which imposed substantial additional responsibilities on directors and officers of public companies, the availability of indemnification, insurance, and other protective mechanisms took on renewed significance for corporate directors and officers. More recently, the turmoil in the financial markets and the resulting increase in litigation,ⁿ² as well as the high-profile failures of several major financial institutions, have once again reinforced the importance of these protective mechanisms. More than ever, individuals considering whether to join or remain on a board know that they will be subject to heightened scrutiny and the prospect of significant threats of liability.

The director settlements at WorldCom, Inc. and Enron Corp. underscored this point.ⁿ³ In March 2005, twelve former nonmanagement directors of WorldCom agreed to pay a total of almost \$25 million of their personal funds to settle class action stockholder litigation arising out of the massive accounting fraud at WorldCom. This settlement agreement revived an earlier agreement that had been reached in January 2005 but failed to receive court approval for technical reasons. Under that agreement, ten former nonmanagement directors had agreed to contribute \$18 million of their personal funds to a \$54 million settlement, representing approximately 20% of their cumulative net worth (excluding certain assets such as their primary residences, retirement accounts and judgment-proof assets). The \$25 million settlement supplemented an additional \$36 million to be paid on the directors' behalf under WorldCom's directors' and officers' liability insurance coverage, ("D&O insurance"). Soon after the announcement of the first WorldCom settlement, it was reported that, in a confidential agreement reached in October 2004, ten former nonmanagement directors of Enron had agreed to pay \$13 million of a \$168 million settlement out of their personal funds in order to resolve claims against them arising out of Enron's fraudulent accounting practices. The remainder of the settlement was to be covered by D&O insurance.

In September 2006, four former nonmanagement directors of Just for Feet, Inc. agreed to pay \$40 million to settle a bankruptcy trustee's claim against them for alleged bad faith, breach of fiduciary duties, misrepresentations and conflicts of interest. The remaining nonmanagement director agreed to pay an additional \$1.5 million in March 2007. The company had collapsed in 1999 amid an accounting fraud and the company's D&O insurance had been largely

exhausted by a \$24.5 million settlement of a 2002 stockholders' securities class action lawsuit. Therefore, the company did not have enough insurance to cover the settlement contributions and, given that it was in bankruptcy, could not indemnify the directors.ⁿ⁴ This is very likely the largest out-of-pocket payment by outside directors stemming from corporate fraud allegations.

Although the WorldCom and Enron settlements resulted from circumstances that involved well-documented and egregious wrongdoing, and directors rarely personally contribute to settlementsⁿ⁵ (notwithstanding the outcomes in WorldCom, Enron and Just for Feet), there is no question that directors and officers today are operating in a more precarious environment that presents increased risks of liability. As a result, public corporations, and their directors and officers, are looking carefully at the nature and extent of the protections that are available to corporate officials. Almost universally, these protections include a combination of charter provisions that may be adopted by stockholders to limit or eliminate the monetary liability of directors (and, in a few states, officers) in specified circumstances, indemnification, and D&O insurance. The availability of robust protections is critical to effective corporate governance because it directly affects a corporation's ability to attract qualified directors and officers. Robust protections are particularly important in view of the growing consensus that changes in corporate governance practices are creating new and heightened expectations for directors.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., 29 U.S.C.).

(n2)Footnote 2. *See, e.g., A Closer Look at the 2008 Securities Lawsuits*, InSights Addendum (Oakbridge Insurance Services), at 1 (Jan./Feb. 2009) (stating that 224 new securities lawsuits were filed in 2008, which was a 30% over 2007 and an 88% increase over 2006, and that of the 224 new lawsuits filed in 2008, 101 were subprime or credit-crisis related).

(n3)Footnote 3. For more discussion of the WorldCom and Enron settlements, *see* 19 Insights No. 2 (Feb. 2005) (Special Issue: Focus on Director Liability).

(n4)Footnote 4. *See* Lauri Floresca & Susan Miner, *D&O Insurance Lessons From 'Just for Feet'*, 31 Directors & Boards No. 5, at 45 (Sept. 2007); Peter Lattman, *Settlement in Just for Feet Case May Fan Board Fears*, The Wall Street Journal, April 23, 2007, *available at* http://online.wsj.com/article/SB117728671802378484.html?mod=todays_us_marketplace.

(n5)Footnote 5. *See* Bernard S. Black, Brian R. Cheffins and Michael Klausner, *Outside Director Liability*, 58 *Stan. L. Rev.* 1055 (2006).



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Corporate Governance: Law and Practice

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CHAPTER 5 LIABILITY OF OFFICERS AND DIRECTORS; STATUTORY LIMITATIONS, INDEMNIFICATION
AND D&O INSURANCE

1-5 Corporate Governance: Law and Practice § 5.02

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§ 5.02 Exculpation under Section 102(b)(7) of the Delaware General Corporation Law

[1] The Genesis of Exculpatory Charter Provisions

An effective corporate governance system depends upon the critical eye and watchful oversight of an independent board. Such a system can succeed only if qualified individuals are willing to serve as directors. By the mid-1980's, there were increasing concerns about the ability of Delaware corporations to attract and retain highly qualified directors due to a contraction in the availability and scope of D&O insurance coverage and an increase in premiums and deductibles, combined with an expansion in litigation involving directors and officers. In particular, the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*, holding that directors could be personally liable for monetary damages for gross negligence in their decision-making processes,ⁿ¹ meant that individuals serving as directors faced the prospect of multi-million dollar judgments. The reluctance of many directors to serve without adequate insurance protection, and the possibility that the specter of liability would discourage directors from making business judgments that entail entrepreneurial risk, or from serving on boards at all, were viewed as "threaten[ing] the quality and stability of the governance of Delaware corporations."ⁿ² It was against this backdrop that Section 102(b)(7) of the Delaware General Corporation Law was enacted in 1986.ⁿ³

The statutory provision was a direct response to the drying up of the market for D&O insurance that followed the *Van Gorkom* decision. A similar tightening of the availability of D&O insurance occurred as a result of the failures of Enron Corp., WorldCom, Inc. and other large corporations, and because of serious issues of management integrity at companies like Adelphia Communications Corporation and Tyco International Ltd. The hardened market for D&O insurance that followed Enron and WorldCom began to soften again in 2004 and continued for several years, but the subprime mortgage meltdown and financial crisis have resulted in a retightening of the market for D&O coverage in the financial services sector, and a leveling off of the market in other sectors after several years of decreasing premiums and more favorable coverage terms in the D&O insurance market as a whole.ⁿ⁴

Section 102(b)(7) of the Delaware General Corporation Law permits a Delaware corporation to include in its original certificate of incorporation or an amendment to the certificate of incorporation a provision limiting or eliminating the personal liability of directors to the corporation and its stockholders for monetary damages for breaches of their

fiduciary duties as directors. Section 102(b)(7) also enumerates several circumstances in which a director's liability for breach of fiduciary duty may *not* be limited or eliminated. Specifically, no provision can eliminate a director's liability for:

- (1) breach of the director's duty of loyalty to the corporation and its stockholders;⁵
- (2) acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law;⁶
- (3) willful or negligent conduct in paying dividends or repurchasing or redeeming stock out of funds that are not lawfully available, in violation of Section 174 of the Delaware General Corporation Law;⁷ or
- (4) any transaction from which the director derives an improper personal benefit.⁸

In large part, these limitations mirror the exclusions traditionally found in D&O insurance policies⁹ and reflect public policy determinations that it would be inappropriate to limit liability in circumstances where there is wrongdoing that involves some level of intent on the part of the director.

Since Section 102(b)(7) was enacted in 1986, nearly all states and the Model Business Corporation Act have followed Delaware's lead and now have provisions permitting stockholders to limit or eliminate the personal monetary liability of directors for breach of certain duties.¹⁰ A few states have taken a different approach and have enacted self-executing statutes that do not require stockholder action to become effective. These statutes alter the standard of care to make claims for monetary damages against directors more difficult.¹¹ As a result of Section 102(b)(7) and similar statutes in other states, the majority of large American corporations now have limitation-of-liability provisions in their charters.¹²

Charter provisions limiting or eliminating liability under Section 102(b)(7) generally take one of two forms. Some faithfully track the language of the statutory provision. Others provide for the limitation or elimination of liability "to the fullest extent permitted by Delaware law," language that is designed to capture any limitations on liability that may be authorized as a result of future amendments to Delaware law.

As discussed in more detail below, Section 102(b)(7) does not provide absolute protection from liability. It does, however, afford directors an added layer of protection by reducing the number of instances in which their personal assets may be put at risk to satisfy a judgment. A charter provision adopted under Section 102(b)(7) supplements the protections afforded by indemnification and D&O insurance.

[2] Extent of Limitations on Liability

Section 102(b)(7) of the Delaware General Corporation Law effectively enables a corporation to limit or eliminate the personal monetary liability of its directors to the corporation and its stockholders for breach of the duty of care, which requires that directors exercise diligence and care in managing the business and affairs of a corporation and exercise an informed business judgment in the discharge of their responsibilities.¹³ However, Section 102(b)(7) expressly prohibits insulation from liability for breach of the duty of loyalty.¹⁴ Although the term "duty of loyalty" is not defined in the Delaware General Corporation Law, this duty essentially requires that the best interests of the corporation and its stockholders take precedence over any interests of the directors that are not shared by the stockholders generally.¹⁵ Because Section 102(b)(7) distinguishes between the duty of care and the duty of loyalty, and does not permit limitation or elimination of liability for breach of the duty of loyalty, the issue of how director conduct is classified can have great significance, although this distinction is not always clear.¹⁶

There are several important limitations on the scope of Section 102(b)(7):

- (1) Section 102(b)(7) permits the limitation or elimination of liability for monetary damages only to a corporation and its stockholders, and not to third parties.
- (2) Section 102(b)(7) does not limit or eliminate equitable remedies, such as injunctive relief, although as a practical matter many such remedies (*e.g.*, an injunction against a transaction approved by the board) must be obtained quickly or they may have little practical effect.ⁿ¹⁷
- (3) Section 102(b)(7) applies only where a director is acting in the capacity of a director. Accordingly, actions taken by a corporate officer who is also a director, while acting as an officer, are outside the scope of Section 102(b)(7).ⁿ¹⁸
- (4) Section 102(b)(7) can only limit or eliminate liability arising under Delaware corporate law and does not apply to liability arising under other laws and regulations, such as the federal securities laws.
- (5) For corporations that do not have a Section 102(b)(7) provision in their original certificate of incorporation, the adoption of such a provision requires the approval of the corporation's stockholders.

Section 102(b)(7) also states that corporations cannot limit or eliminate directors' liability for acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law.ⁿ¹⁹ While Section 102(b)(7) shields directors from liability even for actions that are grossly negligent,ⁿ²⁰ it is unclear whether Section 102(b)(7) can be used to protect directors from liability for actions that are reckless--that is, actions that are more than negligent but fall short of intentional wrongdoing. A handful of commentators have argued that the Delaware statutory provision permits corporations to eliminate totally their directors' liability for recklessness.ⁿ²¹ The more conservative view is that, to the extent that recklessness involves a conscious disregard of known risks, a director whose behavior is reckless has not acted in good faith and would not be eligible for exculpation under Section 102(b)(7).ⁿ²²

One issue that has received increased attention in the post-Enron environment is the extent to which a director's abdication of duty or lack of oversight constitutes a lack of good faith, making the protections of Section 102(b)(7) inapplicable.ⁿ²³ Following the collapse of Enron Corp., Vice Chancellor Strine of the Delaware Court of Chancery published an article in which he suggested that courts may find that a director who is conscious that he or she is not devoting sufficient attention to his or her duties is not acting in good faith, and is therefore not entitled to exculpation from liability under Section 102(b)(7).ⁿ²⁴ Since then, the Delaware courts have addressed the contours of good faith, and the related question of director liability for oversight failures, in a series of decisions holding that directors may not be acting in good faith if they consciously disregard either their responsibilities as board members or known risks to the company that they serve. These decisions arguably reflect a more expansive notion of the concept of "good faith" that has taken hold and that illustrates the evolving expectations on directors in performing their oversight responsibilities.ⁿ²⁵

In *In re Walt Disney Company Derivative Litigation*, the company's stockholders had filed a derivative suit alleging that the board breached its fiduciary duties by "blindly" approving the hiring and compensation of Disney's president, Michael Ovitz. According to the plaintiffs' complaint, neither the compensation committee nor the board reviewed or approved the final terms of Mr. Ovitz's compensation package, instead delegating to chief executive officer Michael Eisner, Mr. Ovitz's close friend of 25 years, responsibility to negotiate and approve significant details of the employment agreement. Both the compensation committee and the board allegedly spent less than one hour each approving Mr. Ovitz's hiring, and did so without considering information about the total potential payout under the agreement, data about industry standards for comparable executives and agreements, or expert advice from compensation consultants. The complaint alleged a "similar, ostrich-like approach" on the part of the board with respect to the process of negotiating Mr. Ovitz's departure from Disney, including a failure to consider alternatives to a nonfault termination provision that allowed Mr. Ovitz to leave Disney after barely one year with a payout (according to the plaintiffs' calculations) that amounted to \$140 million in cash and options.

In 2003, the Delaware Court of Chancery refused to dismiss the complaint against Disney's directors based on a Section 102(b)(7) provision in Disney's charter documents, stating that, if true, the plaintiffs had alleged facts demonstrating that the directors had "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."ⁿ²⁶ The court concluded that "[k]nowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care" is conduct that either is not in good faith or involves intentional misconduct, placing it outside the protection of Section 102(b)(7).ⁿ²⁷

The principle articulated in *Disney I* was subsequently reaffirmed in *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*,ⁿ²⁸ a case that, like *Disney*, alleged breach of fiduciary duties in connection with approval of executive compensation arrangements. In *Integrated Health*, the Delaware Court of Chancery considered whether the directors "consciously and intentionally disregarded their responsibilities" to an extent that they could not be shielded by the company's Section 102(b)(7) provision, stating that:ⁿ²⁹

One may ... conceptualize the holding in *Disney I* as a duty of care claim that is so egregious--that essentially alleges the Board abdicated its responsibility to make any business decision--that it falls within the second exception to the general exculpating power of § 102(b)(7). See 8 *Del. C.* § 102(b)(7)(ii) (preventing exculpation from monetary liability "for acts or omissions not in good faith ...").

In concluding that the protections of Section 102(b)(7) were available for some claims relating to the approval of the compensation arrangements but not others, the court distinguished between claims that involved nondeliberation and those that involved insufficient deliberation:ⁿ³⁰

The facts in this case are different from those in *Disney*. Elkins founded [Integrated Health] and had been an executive of the company for over 10 years at the time of the first Challenged Transaction. Ovitz was at Disney for one year. No expert was retained by Disney, while [compensation consultant] Bachelder (regardless of questions over the method of his selection) was retained by [Integrated Health]. Thus, a change in characterization from a total lack of deliberation (and for that matter, a difference between the meaning of discussion and deliberation, if there is one), to even a short conversation may change the outcome of a *Disney* analysis. Allegations of nondeliberation are different from allegations of not enough deliberation.

The relevant inquiry, according to the court, was whether the board took some action or exercised some business judgment. In circumstances where the board did so, the court could not conclude that the board had consciously and intentionally disregarded its duties and had not acted in good faith, and therefore, Section 102(b)(7) would prevent the imposition of liability.ⁿ³¹

On August 9, 2005, following a lengthy trial, the Delaware Court of Chancery issued its long-awaited opinion in *The Walt Disney Company* litigation and on June 8, 2006, the Supreme Court of Delaware affirmed.ⁿ³² Among other things, the Court of Chancery held, and the Supreme Court affirmed the holding, that Disney's directors did not breach their fiduciary duties in connection with Ovitz's hiring and termination. Although the Court of Chancery had found (and the Supreme Court agreed) that "many aspects of defendants' conduct ... fell significantly short of the best practices of ideal corporate governance,"ⁿ³³ the Court of Chancery concluded that "Delaware law does not ... hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices."ⁿ³⁴ However, after noting that a "fiduciary's duties do not change over time,"ⁿ³⁵ the Court of Chancery went on to state that "[h]ow we understand those duties may evolve and become refined."ⁿ³⁶ Accordingly, the liability standards applied to acts or omissions by directors today may be different from those applied to Disney's directors as a result of the corporate governance developments that have occurred in the ten years since the events giving rise to the *Disney* litigation.

Ultimately, the Section 102(b)(7) provision in Disney's charter documents did not affect the outcome of the litigation because the Delaware Court of Chancery concluded that Disney's directors had not acted in bad faith. In determining whether directors have acted in good faith, the Delaware Court of Chancery held that "the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard."ⁿ³⁷ In affirming the Court of Chancery's judgment, the Supreme Court of Delaware upheld this definition as "a legally appropriate, although not the exclusive, definition of fiduciary bad faith."ⁿ³⁸ The Delaware Supreme Court also addressed an issue that had not been entirely clear from the Court of Chancery's opinion--that is, how allegations of a lack of good faith should be treated for purposes of determining whether exculpation from liability is available under Section 102(b)(7). Acknowledging that the contours of the duty of good faith remain "relatively uncharted" and that there has been "an increased recognition of the importance of good faith,"ⁿ³⁹ the Delaware Supreme Court stated that "some conceptual guidance to the corporate community may be helpful."ⁿ⁴⁰ In providing this guidance, the Delaware Supreme Court explicitly rejected the argument that a breach of the duty of care (which requires conduct involving gross negligence) would automatically constitute a failure to act in good faith.ⁿ⁴¹ The Delaware Supreme Court further concluded that the definition of conduct not in good faith articulated by the Court of Chancery in *Disney II*--an "intentional dereliction of duty, a conscious disregard for one's responsibilities"--is properly treated as a non-exculpable, non-indemnifiable violation of the duty to act in good faith. According to the Supreme Court:ⁿ⁴²

[T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense ... or gross negligence [the standard for finding a violation of the duty of care]. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.

In reaching its conclusion, the Supreme Court of Delaware also looked to the language of Section 102(b)(7), which prohibits elimination of a director's liability for acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law.ⁿ⁴³ Because Section 102(b)(7) only permits elimination of liability for a breach of the duty of care (which requires conduct involving gross negligence), the Delaware Supreme Court concluded that Section 102(b)(7)'s denial of exculpation for acts not in good faith "must encompass the intermediate category of misconduct captured by the [Delaware Court of Chancery's] definition of 'bad faith.'"ⁿ⁴⁴

In a subsequent case, the Supreme Court of Delaware addressed the issue of whether there is a separate fiduciary duty of good faith under Delaware law, in addition to the fiduciary duties of care and loyalty. The issue arose in a case involving the standard to be applied under Delaware law when assessing the personal liability of corporate directors for failing to oversee a corporation adequately.ⁿ⁴⁵ In *Stone v. Ritter*, the Delaware Supreme Court affirmed the Court of Chancery's decision to apply the so-called *Caremark* standardⁿ⁴⁶ for assessing a director's potential personal liability for failing to act in good faith in discharging his or her oversight responsibilities. In affirming this decision, the Supreme Court of Delaware observed that the *Disney III* case had left open the issue of whether a failure to act in good faith, by itself, can serve as a basis for the imposition of liability.ⁿ⁴⁷ The Delaware Supreme Court concluded that, although the duty to act in good faith could be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.ⁿ⁴⁸ However, a showing of bad faith conduct can still result indirectly in liability because a director's failure to act in good faith is a breach of the director's duty of loyalty.ⁿ⁴⁹ In this regard, the Delaware Supreme Court stated that "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."ⁿ⁵⁰

The Delaware Court of Chancery reiterated this principle in *In re Citigroup Inc. Shareholder Derivative Litigation*,

stating that "a showing of bad faith is a *necessary condition* to oversight liability."ⁿ⁵¹ In *Citigroup*, the court dismissed claims against current and former Citigroup directors alleging that they failed adequately to oversee and manage the risks that the company faced from exposure to the problems in the subprime mortgage market in 2007 and 2008, even in the face of alleged "red flags." In addressing the plaintiffs' claims, the Court of Chancery noted that the company had a Section 102(b)(7) charter provision. As a result, the court observed that "a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated claim* ... based on particularized facts."ⁿ⁵² To plead a claim for oversight failures, which (as noted above) are rooted in bad faith, the court stated that it would be necessary for a plaintiff to allege particularized facts showing that a director consciously disregarded an obligation to be reasonably informed about a company's business and its risks or consciously disregarded the duty to monitor and oversee the company's business.ⁿ⁵³ After noting that this placed an extremely high burden on the Citigroup plaintiffs,ⁿ⁵⁴ the court concluded that the plaintiffs had failed to meet this burden and dismissed all but one of their claims, including their claims for oversight failures. In doing so, the court noted that the plaintiffs' allegations amounted to little more than a claim that Citigroup had suffered large losses, that there were warning signs about the risks Citigroup faced in the subprime mortgage market, and that, because the directors failed to prevent the losses, the directors must have consciously ignored the warning signs or knowingly failed to monitor the company's risks.ⁿ⁵⁵

The foregoing cases illustrate that, under Delaware law, directors who engage in conduct that amounts to an intentional dereliction of duty or conscious disregard for their responsibilities will not be entitled to exculpation under Section 102(b)(7). This conduct is both conduct not in good faith and a breach of the duty of loyalty. Although the Supreme Court of Delaware made clear in *Disney III* that a breach of the duty of care does not equate with a failure to act in good faith, to the extent that conduct can be characterized as involving a lack of good faith, and therefore, a violation of the duty of loyalty,ⁿ⁵⁶ it is likely to be more difficult to obtain dismissal of complaints in reliance on a Section 102(b)(7) provision.ⁿ⁵⁷ However, as the result in *Citigroup* demonstrates, it remains difficult to state a claim against directors for oversight liability based on the failure to perform their oversight responsibilities.ⁿ⁵⁸

[3] Procedural Aspects of Invoking Section 102(b)(7)

In 2001, the Supreme Court of Delaware decided two cases that address when and how directors can invoke a limitation-of-liability provision adopted under Section 102(b)(7), *Malpiede v. Towson* ⁿ⁵⁹ and *Emerald Partners v. Berlin*.ⁿ⁶⁰ Specifically, the cases address the circumstances in which directors can rely on Section 102(b)(7) in the early stages of litigation, prior to discovery and a long and costly trial on the merits. One of the beneficial effects of an exculpatory charter provision "is to guarantee that ... directors do not suffer discovery or a trial simply because the plaintiffs have stated a non-cognizable damages claim for a breach of the duty of care."ⁿ⁶¹ Accordingly, the ability to invoke a Section 102(b)(7) provision at the start of litigation is significant. "To give [an] exculpatory charter provision any less substantial effect would be to strip away a large measure of the protection" provided by Section 102(b)(7).ⁿ⁶²

A charter provision adopted under Section 102(b)(7) is "in the 'nature of an affirmative defense' " and must be affirmatively raised by the director defendants.ⁿ⁶³ In *Malpiede v. Towson*, the Supreme Court of Delaware held that, when the business judgment rule provides the standard of review in a case, raising the existence of a valid Section 102(b)(7) provision in the corporate charter entitles a director to dismissal of any claims for monetary damages that are based solely on alleged breaches of the duty of care.ⁿ⁶⁴ The business judgment rule is a presumption that, in making a business decision, a corporation's directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."ⁿ⁶⁵ The effect of the business judgment rule is to place the burden on the plaintiff to rebut the presumption of regularityⁿ⁶⁶ by showing that, in reaching its decision, the board "breached any one of its triad of fiduciary duties: due care, loyalty, or good faith."ⁿ⁶⁷

Under *Malpiede* and the Supreme Court of Delaware's subsequent decision in *Emerald Partners v. Berlin*,ⁿ⁶⁸ one procedure governs reliance on a Section 102(b)(7) provision where the well-pleaded facts allege only breach of the duty of care and a different procedure governs where a plaintiff overcomes the presumption of the business judgment rule by alleging breach of the duties of loyalty or good faith. *Malpiede* establishes that, where a plaintiff successfully alleges

only violations of the duty of care, a trial on the merits is unnecessary because Section 102(b)(7) would bar the defendants' liability for monetary damages that are attributable to violations of the duty of care.ⁿ⁶⁹ Accordingly, when a company has a Section 102(b)(7) charter provision and the complaint fails to allege facts that, if true, would implicate a breach of the duties of loyalty or good faith, the complaint can be dismissed at the outset of the litigation.ⁿ⁷⁰

In *Emerald Partners v. Berlin*,ⁿ⁷¹ the Supreme Court of Delaware established the procedure for determining the exculpatory effect of Section 102(b)(7) provisions where a plaintiff has rebutted the presumption of the business judgment rule by alleging a violation of the duty of loyalty or the failure to act in good faith. Where (as in *Emerald Partners*) a transaction is challenged and the business judgment rule is rebutted in connection with the transaction, the burden shifts to the defendant directors to prove that the transaction was "entirely fair" to the plaintiff stockholder.ⁿ⁷² In *Emerald Partners*, the Supreme Court of Delaware held that, when entire fairness is the applicable standard of review, a determination that directors are not liable for monetary damages under an exculpatory charter provision can be made only *after* the trier of fact decides whether the transaction was entirely fair.ⁿ⁷³

The rationale for making a determination of entire fairness a "condition precedent to any consideration of damages"ⁿ⁷⁴ is that the requirement of entire fairness is "unflinching in its demand."ⁿ⁷⁵ Accordingly, unlike where violations of the duty of care are alleged, directors cannot avoid having to demonstrate entire fairness by pointing to the existence of a Section 102(b)(7) provision and making the argument that, even if the transaction were determined to be unfair, the plaintiffs could not collect monetary damages. When the Supreme Court of Delaware remanded the case in *Emerald Partners*, it instructed the Court of Chancery to address the Section 102(b)(7) charter provision only if it determined that the challenged transaction was not entirely fair, at which point the issue of exculpation under Section 102(b)(7) could be examined in light of that finding.ⁿ⁷⁶ At that point, the directors may "avoid personal liability for paying monetary damages only if they have established that their failure to withstand an entire fairness analysis is exclusively attributable to a violation of the duty of care."ⁿ⁷⁷ In affirming the Delaware Court of Chancery decision that the transaction was entirely fair, the Supreme Court of Delaware, citing the Court of Chancery holding in the *Disney I* case,ⁿ⁷⁸ concurred that there were "process flaws" in the negotiations leading up to the transaction that "raise[d] serious questions as to the independent directors' good faith."ⁿ⁷⁹ However, the court declined to address the good faith issue because, even if the directors would not be protected by the Section 102(b)(7) charter provision due to a lack of good faith, they were not liable for monetary damages in view of the conclusion that the transaction was entirely fair.ⁿ⁸⁰

The rule articulated by the Supreme Court of Delaware in its decisions in *Malpiede* and *Emerald Partners*--that a director defendant bears the burden of pleading and establishing the elements of a defense based on Section 102(b)(7) unless only a violation of the duty of care is alleged--has been criticized on the ground that it effectively requires directors to establish that their conduct does not fall within any of the exceptions set forth in Section 102(b)(7), such as breach of the duty of loyalty.ⁿ⁸¹ The effect of these decisions is to limit the disposition under Section 102(b)(7) of claims in the early stages of litigation to cases alleging only violations of the duty of care. Where a breach of the duty of loyalty or a failure to act in good faith is successfully alleged, and the presumption of the business judgment rule rebutted, a court may assess the application of a Section 102(b)(7) charter provision only after discovery and a trial involving an assessment of the director's conduct. Moreover, as the concept of good faith increasingly becomes a subject of focus, as exemplified by the decisions in the *Disney* litigation and the *Integrated Health* and *Stone* cases,ⁿ⁸² the *Malpiede* and *Emerald Partners* decisions may result in even fewer cases being dismissed on the pleadings under Section 102(b)(7) charter provisions. In the *Disney I* and *Integrated Health* cases, as noted above, the Court of Chancery refused to dismiss complaints against the companies' directors in reliance on the companies' Section 102(b)(7) provisions, with the result that the cases would proceed to discovery and trial. Although the Supreme Court of Delaware did make clear in *Disney III* that a breach of the duty of care does not automatically equate with a failure to act in good faith,ⁿ⁸³ to the extent that conduct can be characterized as not in good faith, it is likely to become correspondingly easier for plaintiffs to plead violations of the duty of loyalty, and thus, to defeat defendants' ability to rely on Section 102(b)(7) provisions as a means of dismissing litigation at an early stage.ⁿ⁸⁴

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Care Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Loyalty

FOOTNOTES:

(n1)Footnote 1. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

(n2)Footnote 2. S.B. 533, 133rd Gen. Assem. (synopsis) (Del. 1986). The synopsis to the bill explains that

Section 102(b)(7) and the amendments to Section 145 represent a legislative response to recent changes in the market for directors' liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of the traditional policies (and, in many cases, the unavailability of any type of policy from the traditional insurance carriers) have threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances.

(n3)Footnote 3. *Del. Code Ann. tit. 8, § 102(b)(7)* (2009).

(n4)Footnote 4. *See § 5.04[1] below.*

(n5)Footnote 5. *Del. Code Ann. tit. 8, § 102(b)(7)(i)* (2009).

(n6)Footnote 6. *Del. Code Ann. tit. 8, § 102(b)(7)(ii)* (2009).

(n7)Footnote 7. *Del. Code Ann. tit. 8, § 102(b)(7)(iii)* (2009).

(n8)Footnote 8. *Del. Code Ann. tit. 8, § 102(b)(7)(iv)* (2009).

(n9)Footnote 9. D&O insurance exclusions are discussed in § 5.04[4] below.

(n10)Footnote 10. *See* Model Bus. Corp. Act Ann. § 2.02(b)(4) (4th ed. 2008). All but a handful of states (Florida, Indiana, Ohio and Wisconsin) and the District of Columbia expressly permit the inclusion of a provision in the certificate of incorporation, charter or bylaws limiting or eliminating the personal liability of directors. *See also* Mark A. Sargent & Dennis R. Honabach, *D&O Liability Handbook: Law-Sample Documents-Forms* (Thomson West 2009) (compiling and discussing the relevant statutory provisions of various jurisdictions). *See also* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters* 7-12. (European Corporate Governance Institute Working Paper Series in Law, Working Paper No. 34/2005 (Apr. 2005)), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=706522 (discussing approaches taken by different jurisdictions). Several states also permit or provide by statute for limitation of monetary liability for officers. *See, e.g., La. Rev. Stat. Ann. § 12:24(C)(4)* (2008); *Md. Code Ann., Corps. & Ass'ns §§ 2-104(b)(8), 2-405.2* (2008); *Nev. Rev. Stat. § 78.138(7)* (2009); *N.H. Rev. Stat. Ann. § 293-A:2.02(b)(4)* (2009); *N.J. Stat. Ann. § 14A:2-7(3)* (2009); *Utah Code Ann. § 16-10a-840(4)* (2008); *Va. Code Ann. § 13.1-692.1(A)* (2009).

(n11)Footnote 11. *See, e.g., Fla. Stat. ch. 607.0831(1)(b)(5)* (2009) (directors not personally liable to a corporation or any other person unless the breach of, or failure to perform, their duties constitutes "recklessness or an act or omission which was committed in bad faith or with malicious purpose or in a manner exhibiting wanton and willful disregard of human rights, safety, or property"; *see also Fla. Stat. ch. 607.0831(2)* (2009) (definition of "recklessness"); *Ind. Code Ann. § 23-1-35-1(e)* (2009) (directors not liable for breach of or failure to perform duties unless breach or failure constitutes "willful misconduct or recklessness"); *Ky. Rev. Stat. Ann. § 271B.8-300(5)* (2009) (in addition to any other limitations set forth in an exculpatory charter provision adopted pursuant to Section 271B.2-020, directors are not liable for breach of or failure to perform duties unless such breach or failure constitutes "willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders"); *Ohio Rev. Code Ann. § 1701.59(D)* (2009) (a director is liable in damages only if proved by clear and convincing evidence that the director acted with deliberate intent to cause injury to the corporation or with reckless disregard for the corporation's best interests, unless the corporation opts in its charter or bylaws not to be governed by this standard); *Utah Code Ann. § 16-10a-840(4)* (2008) (directors not liable to a corporation, its shareholders, or any conservator, receiver, or assignee or successor-in-interest thereof, for breach of or failure to perform duties unless such breach or failure constitutes "gross negligence, willful misconduct, or intentional infliction of harm on the corporation or the shareholders"); *Wis. Stat. §§ 180.0828(1)(a)-(d)* (2008) (directors not liable to a corporation or its shareholders for breach of or failure to perform duties unless such breach or failure constitutes a "willful failure to deal fairly with the corporation or its shareholders in connection with a matter in which the director has a material conflict of interest ... [a] violation of criminal law (unless the director had reasonable cause to believe that his or her conduct was lawful or no reasonable cause to believe that his or her conduct was unlawful) ... [a] transaction from which the director derived an improper personal profit ... [or] [w]illful misconduct").

(n12)Footnote 12. A study of 100 companies in the "Fortune 500" demonstrated that: (1) 98 of the stock corporations incorporated in jurisdictions that permit exculpatory charter provisions had such provisions; and (2) every Delaware corporation had adopted an exculpatory charter provision. Out of a sample of 100 small- and mid-capitalization companies, all but one of those incorporated in jurisdictions that permit exculpatory charter provisions had them. Lawrence A. Hamermesh, *Fiduciary Duty, Limited Liability, and the Law of Delaware: Why I Do Not Teach Van Gorkom*, 34 *Ga. L. Rev.* 477, 490 & App. A (2000); *see also* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 *Emory L.J.* 1155, 1160-61 & n.11 (1990) (in a random sample of 180 Delaware corporations listed on the NYSE or NASDAQ, 90 percent had adopted a limitation-of-liability provision within one year of the enactment of Section 102(b)(7)).

(n13)Footnote 13. *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) . Liability for breach of the duty of care requires a finding by a court that a director was grossly negligent. *See, e.g., Van Gorkom at 873* (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)) .

(n14)Footnote 14. *Del. Code Ann. tit. 8, § 102(b)(7)(i)* (2009); *Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993), *aff'd*, 681 A.2d 1050 (Del. 1996) ("the legislative history of [Section 102(b)(7)] indicates that corporations are empowered to shield directors from breaches of the duty of care, not the duty of loyalty" (citations omitted)).

(n15)Footnote 15. *See, e.g., Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citations omitted).

(n16)Footnote 16. *See* 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.16 & n.695 (3d ed. Supp. 2009) (noting that although the concepts of loyalty and due care seem analytically distinct, the cases have blurred the distinction, and some cases have used the concepts almost interchangeably in describing the same breach of duty).

(n17)Footnote 17. *See, e.g., Zirn v. VLI Corp.*, 681 A.2d 1050, 1062 (Del. 1996) . In *Zirn*, the Supreme Court of Delaware held that although VLI Corp.'s directors had breached their duty of care by making materially misleading partial disclosures in connection with a tender offer, they were protected from liability for monetary damages by an exculpatory charter provision approved by VLI Corp.'s stockholders under Section 102(b)(7). In noting that its decision

would leave the plaintiff stockholders with no redress, the court also pointed out that they could have sought injunctive relief if they had acted earlier and demonstrated the disclosure violations ultimately found by the court.

(n18)Footnote 18. According to one member of the Corporation Law Section of the Delaware State Bar Association, which drafted Section 102(b)(7), this limitation "reflects again the limited purpose of the statute" to encourage outside directors to serve and "to right the balance" between attracting and retaining qualified directors, on the one hand, and preserving the threat of personal liability as a mechanism for policing their actions, on the other hand. "It was not felt that the increased perception of risk of personal liability coupled with the unavailability of D&O insurance were sufficient to cause officers, who depend upon a corporation for their livelihood, to resign or refuse to serve." A. Gilchrist Sparks III, *Delaware's D&O Liability Law; Other States Should Follow Suit*, Legal Times, Aug. 18, 1986, at 10. Some states do permit corporations to exculpate officers from liability through charter or bylaw provisions. *See, e.g., La. Rev. Stat. Ann. § 12:24(C)(4)* (2008); *Md. Code Ann., Corps. & Ass'ns §§ 2-104(b)(8), 2-405.2* (2008); *N.J. Stat. Ann. § 14A:2-7(3)* (2009); *Va. Code Ann. § 13.1-692.1(A)* (2009). In 2009, the Supreme Court of Delaware explicitly held for the first time that officers have the same fiduciary duties as directors, confirming a point that had previously been addressed in dicta and had been a subject of consensus among practitioners. *Gantler v. Stephens*, 965 A.2d 695 (Del. Ch. 2009). However, the court noted that the consequences of a breach of fiduciary duty may not be the same for officers as for directors because of the availability of Section 102(b)(7) to directors. *Gantler*, 965 A.2d at 708-09 & n.36 (Del. Ch. 2009).

(n19)Footnote 19. *Del. Code Ann. tit. 8, § 102(b)(7)(ii)* (2009).

(n20)Footnote 20. *See McPadden v. Sidhu*, 964 A.2d 1262, 1273-74 (Del. Ch. 2008); *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, 2004 Del. Ch. LEXIS 122, at * 34 n.37 (Aug. 24, 2004) (unpublished).

(n21)Footnote 21. *See, e.g., Matthew R. Berry, Does Delaware's Section 102(b)(7) Protect Reckless Directors from Personal Liability--Only if Delaware Courts Act in Good Faith*, 79 Wash. L. Rev. 1125 (2004); J. Brad Wiggins, *Delaware's D & O Liability Law, A 'Windfall' for Directors*, Legal Times, Aug. 18, 1986, at 11.

See also Leo Strine et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law* (The Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 630, at 89 & n. 242 (Mar. 2009)), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1349971 (noting the blurring of the distinctions between gross negligence, recklessness and bad faith and arguing that, to be faithful to Section 102(b)(7), courts must distinguish between conduct that involves bad faith, and is therefore not exculpable, and conduct that is grossly negligent and protected by Section 102(b)(7)).

(n22)Footnote 22. *See* John F. Olson et al., *Director and Officer Liability: Indemnification and Insurance* § 1:20 (Thomson West 2003 (revision by Jennifer Berger & Mitchell A. Kaufman)); 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.13[B] (3d ed. Supp. 2009); *see also* *McCall v. Scott*, 239 F.3d 808, amended by 250 F.3d 997, 1000-01 (6th Cir. 2001) (court applying Delaware law concluded that reckless misconduct could constitute a breach of the duty of good faith that would make the protections of Section 102(b)(7) unavailable).

(n23)Footnote 23. *See, e.g., John L. Reed & Matt Neiderman, "Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 Del. J. Corp. L. 111 (2004).

(n24)Footnote 24. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 Bus. Law. 1371, 1385 & 1393 (2002).

(n25)Footnote 25. *See, e.g., Jonathan C. Dickey & Marshall R. King, Delaware's Duty of Oversight-- Directors*

Prevail in the Citigroup Subprime Litigation, 6 Securities Litigation Report No. 4, at 1, 7 (Apr. 2009) (noting that the evaluation of a board's duty of oversight "often is partly reflective of the 'best practices' environment within which the board operates," and that the economic crisis and subsequent government attempts to enhance risk management may "raise the bar for corporate boards generally in connection with their oversight duties and responsibilities."). *But see* E. Norman Veasey, *A Perspective on Liability Risks to Directors in Light of Current Events*, 19 Insights No. 2, at 9, 13, 14 (Feb. 2005) (although "expectations that boards will implement modern governance norms ... have been rising," the substantive law has not changed and directors who act reasonably and in good faith will be protected from liability).

(n26)Footnote 26. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003) (*Disney I*).

(n27)Footnote 27. *Disney I*, 825 A.2d at 286 , 289-290.

(n28)Footnote 28. *Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins*, 2004 Del. Ch. LEXIS 122 (Aug. 24, 2004) (unpublished).

(n29)Footnote 29. *Integrated Health*, 2004 Del. Ch. LEXIS 122 , at * 34 n.37.

(n30)Footnote 30. *Integrated Health*, 2004 Del. Ch. LEXIS 122, at *47 .

(n31)Footnote 31. *See Integrated Health*, 2004 Del. Ch. LEXIS 122, at *44-60 .

(n32)Footnote 32. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005) (*Disney II*); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006) (*Disney III*).

(n33)Footnote 33. *Disney II*, 907 A.2d at 697 .

(n34)Footnote 34. *Disney II*, 907 A.2d at 697 .

(n35)Footnote 35. *Disney II*, 907 A.2d at 697 .

(n36)Footnote 36. *Disney II*, 907 A.2d at 697 .

(n37)Footnote 37. *Disney II*, 907 A.2d at 697 .

(n38)Footnote 38. *Disney III*, 906 A.2d at 67.

(n39)Footnote 39. *Disney III*, 906 A.2d at 64.

(n40)Footnote 40. *Disney III*, 906 A.2d at 64.

(n41)Footnote 41. *Disney III*, 906 A.2d at 64-65.

(n42)Footnote 42. *Disney III*, 906 A.2d at 66.

(n43)Footnote 43. *See* § 5.02[1] above.

(n44)Footnote 44. *Disney III*, 906 A.2d at 67.

(n45)Footnote 45. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) .

(n46)Footnote 46. *See In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996) .

(n47)Footnote 47. *Stone*, 911 A.2d at 370-71 & n.29 (citing *Disney III*, 906 A.2d at 67 n.112 (Del. 2006)).

(n48)Footnote 48. *Stone*, 911 A.2d at 370 (citations omitted).

(n49)Footnote 49. *Stone*, 911 A.2d at 370 (citations omitted).

(n50)Footnote 50. *Stone*, 911 A.2d at 370 (citations omitted).

(n51)Footnote 51. *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009) (citations omitted).

(n52)Footnote 52. *In re Citigroup*, 964 A.2d at 124-25 (citations omitted).

(n53)Footnote 53. *In re Citigroup*, 964 A.2d at 125.

(n54)Footnote 54. *In re Citigroup*, 964 A.2d at 125.

(n55)Footnote 55. *In re Citigroup*, 964 A.2d at 126-27.

(n56)Footnote 56. *See Stone*, 911 A.2d at 362 .

(n57)Footnote 57. *See § 5.02[3] below.*

(n58)Footnote 58. *In re Citigroup*, 964 A.2d at 125 (noting that director liability based on the duty of oversight is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" and that the combination of the business judgment rule, the protection of a Section 102(b)(7) provision, and the difficulty of proving a claim based on oversight failures "together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.") (citations omitted).

(n59)Footnote 59. *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001) .

(n60)Footnote 60. *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) , *remanded to 2003 Del. Ch. LEXIS 42 (Apr. 28, 2003)* , *aff'd* 840 A.2d 641 (Del. 2003) .

(n61)Footnote 61. *McMillan v. Intercargo Corp.*, 768 A.2d 492, 501-02 (Del. Ch. 2000) ; *see also* Stephen A. Radin, *Director Protection Statutes after Malpiede and Emerald Partners*, 16 Insights No. 2, at 10, 14 (Feb. 2002) ("In light of the high cost of shareholder litigation, the usefulness of director protection statutes turns in large measure on the ability of directors to rely on charter provisions adopted in accordance with these statutes in the context of motions to dismiss filed at the outset of litigation and before discovery. Requiring directors to defend such litigation beyond the motion to dismiss stage eviscerates the protection provided by director protection statutes and thus undermines the policy behind the statutes.").

(n62)Footnote 62. *McMillan v. Intercargo Corp.*, 768 A.2d 492, 502 (Del. Ch. 2000) (citations omitted).

(n63)Footnote 63. *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) (quoting *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223 (Del. 1999) and citing *Malpiede v. Townson*, 780 A.2d 1075, 1095 & n.70 (Del. 2001)) .

(n64)Footnote 64. *Malpiede v. Townson*, 780 A.2d 1075, 1095-96 & n.70 (Del. 2001) . The court, "[a]s guidance for future cases," also cited several methods for raising and arguing the applicability of a Section 102(b)(7) provision. It stated that the Section 102(b)(7) defense could be raised: (1) on a Rule 12(b)(6) motion to dismiss (with or without the filing of an answer); (2) on a motion for judgment on the pleadings (after filing an answer); or (3) on a motion for summary judgment (or partial summary judgment) under Rule 56 after an answer, with or without supporting affidavits. *Malpiede*, 780 A.2d at 1092 (citations omitted).

(n65)Footnote 65. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citations omitted). *See § 4.03[5] above*

(discussing business judgment rule).

(n66)Footnote 66. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)) .

(n67)Footnote 67. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995) (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)) .

(n68)Footnote 68. *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) . For a discussion of the Supreme Court of Delaware's decisions in *Malpiede* and *Emerald Partners*, see Stephen A. Radin, *Director Protection Statutes after Malpiede and Emerald Partners*, 16 Insights No. 2, at 10 (Feb. 2002); Edward B. Micheletti & Seth M. Beausang, *Recent Developments in Delaware Corporate Law*, 5 Del. L. Rev. 251, 251-54 (2002).

(n69)Footnote 69. *Emerald Partners*, 787 A.2d at 92 (discussing *Malpiede*).

(n70)Footnote 70. *Malpiede*, 780 A.2d, at 1093-1094; see also *Emerald Partners*, 787 A.2d at 92 .

(n71)Footnote 71. *Emerald Partners*, 787 A.2d 85 (Del. 2001) .

(n72)Footnote 72. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (citations omitted).

(n73)Footnote 73. *Emerald Partners*, 787 A.2d at 94-96 .

(n74)Footnote 74. *Emerald Partners*, 787 A.2d at 95 .

(n75)Footnote 75. *Emerald Partners*, 787 A.2d at 96 (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)) .

(n76)Footnote 76. Although the Delaware Court of Chancery found on remand that the transaction at issue in the *Emerald Partners* litigation was entirely fair, the court went on to address the availability of the Section 102(b)(7) charter provision in its opinion. See *Emerald Partners v. Berlin*, 2003 Del. Ch. LEXIS 42, at *133-*149 (Apr. 28, 2003) (*Emerald Partners II*) , *aff'd*, 840 A.2d 641 (Del. 2003) . After noting the Delaware Supreme Court's conclusion that, if the transaction were found to be entirely fair, no further analysis was necessary, the Court of Chancery indicated that it was addressing the availability of the exculpatory charter provision for two reasons: (1) the likelihood of an appeal given the lengthy history of appellate review in the case; and (2) the desirability of avoiding, if possible, a further remand in the event that the Court of Chancery's entire fairness determination was overturned. *Emerald Partners II*, 2003 Del. Ch. LEXIS 42 , at *72-*74 & n.63, *133-*134 & n.129 (citing *Emerald Partners v. Berlin*, 787 A.2d 85, 98 (Del. 2001)) . For purposes of its analysis, the court assumed that the merger was not entirely fair and considered whether the unfairness was the product of a breach of the duty of care or the duty of loyalty. *Emerald Partners II*, 2003 Del. Ch. LEXIS 42, at *135-*149 . The court concluded that, even if the merger had been found not to be entirely fair, the unfairness would have been, at most, solely the result of a breach of the duty of care and that, as a result, the defendant directors would be exculpated from monetary liability under the Section 102(b)(7) charter provision. *Emerald Partners II*, 2003 Del. Ch. LEXIS 42, at *135, *149 .

(n77)Footnote 77. *Emerald Partners v. Berlin*, 787 A.2d 85, 98 (Del. 2001) .

(n78)Footnote 78. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (*Disney I*); see § 5.02[2] above.

(n79)Footnote 79. *Emerald Partners v. Berlin*, 840 A.2d 641 (Del. 2003), 2003 Del. LEXIS 639, at *2 & n.4 (Dec. 23, 2003).

(n80)Footnote 80. *Emerald Partners*, 840 A.2d 641 (Del. 2003), 2003 Del. LEXIS 639, at *3 .

(n81)Footnote 81. *See, e.g.,* William T. Allen *et al.*, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 *Nw. U.L. Rev.* 449, 462-64 & n.50 (2002); William T. Allen *et al.*, *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 *Bus. Law.* 1287, 1304-05 (2001) (both arguing that directors should have to do nothing to establish a Section 102(b)(7) defense other than point to the existence of the statutory provision to establish that they cannot be held liable for any breaches of the duty of care, and stating that requiring directors to disprove the duty-of-loyalty exception to Section 102(b)(7) undercuts the purpose of the provision, leaves directors who raise it as a defense worse off procedurally than those who do not, and increases the likelihood that meritless claims will survive motions to dismiss).

(n82)Footnote 82. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (*Del. Ch.* 2003) ; *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (*Del. Ch.* 2005) ; *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (*Del.* 2006) ; *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, 2004 *Del. Ch. LEXIS* 122 (*Aug. 24, 2004*) (unpublished); *Stone v. Ritter*, 911 A.2d 362 (*Del.* 2006) ; *see* § 5.02[2] above.

(n83)Footnote 83. *Disney III*, 906 A.2d 27, at 64-65 .

(n84)Footnote 84. *See, e.g.,* Creighton Condon, *Keeping the "Good" Faith: The Evolving Duties--and Potential Personal Liability--of Corporate Directors*, 7 *The M&A Lawyer* No. 2, at 1 (June 2003) (concluding that "if directors fail to exercise appropriate due care in the performance of their duties, courts will be open to 'good faith' claims by plaintiffs--with attendant personal liability for directors--that cannot be indemnified").



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Corporate Governance: Law and Practice

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CHAPTER 5 LIABILITY OF OFFICERS AND DIRECTORS; STATUTORY LIMITATIONS, INDEMNIFICATION
AND D&O INSURANCE

1-5 Corporate Governance: Law and Practice § 5.03

AUTHOR: Gillian McPhee

§ 5.03 Indemnification

[1] Introduction and Background

Like exculpatory charter provisions, indemnification can be an important tool in attracting qualified individuals to serve as directors. While charter provisions under Section 102(b)(7) of the Delaware General Corporation Law or similar statutes can limit or eliminate directors' liability for monetary damages, indemnification can protect directors and other corporate officials from the expenses of litigation and, in some cases, from the cost of settlements or judgments.

Indemnification is one person's agreement to pay for the debts of another. In the present context, it is the use of a corporation's funds to compensate its officials for personal losses they have incurred as a consequence of the proper conduct of their official responsibilities.ⁿ¹ Indemnification rights are generally governed by the law of the jurisdiction in which a company is incorporated.ⁿ² The Delaware General Corporation Law and the corporation statutes of most states specify the circumstances in which a corporation is permitted, and in some instances, required to indemnify its directors, officers and other corporate officials against liabilities and related expenses incurred in connection with their service to a corporation.ⁿ³

For purposes of illustrating some fundamental principles about how indemnification works, this discussion will focus on the indemnification provisions of the Delaware General Corporation Law, both because of Delaware's popularity as a jurisdiction of incorporation and because Delaware's indemnification statute, set forth in Section 145 of the Delaware General Corporation Law,ⁿ⁴ has served as a model for a number of other jurisdictions.ⁿ⁵

Section 145 of the Delaware General Corporation Law, like analogous statutory provisions in other states, serves the dual purposes of:ⁿ⁶

- (a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and
- (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the cost of defending their honesty and integrity.

Consistent with applicable law, the rights granted under state indemnification statutes can be modified and tailored to meet a corporation's needs through the use of charter and bylaw provisions, as well as indemnification agreements.

[2] Who Is Eligible for Indemnification

One of the threshold issues to be addressed in considering indemnification is who is entitled to receive indemnification. Eligibility for indemnification generally depends on an individual's position at a corporation, as well as the capacity in which the individual is acting. Although this discussion focuses on the indemnification of directors because of their role in the governance of a corporation, the Delaware statute also permits indemnification and advancement of expenses for officers, employees and agents.ⁿ⁷ In each case, the entitlement to indemnification arises "by reason of the fact that the person is or was a director, officer, employee or agent of the corporation."ⁿ⁸ Indemnification also protects directors, officers, employees or agents of the indemnifying corporation who serve at the corporation's request in any of these positions at another entity.ⁿ⁹

In the absence of action by a Delaware corporation to limit continuing indemnification, indemnification continues after an individual has ceased to be a director, officer, employee or agent of a corporation, and inures to the benefit of the individual's heirs, executors and administrators, with respect to actions, suits or proceedings arising out of events that occurred during the period of an individual's service to the corporation.ⁿ¹⁰ In addition, under 2009 amendments to the Delaware General Corporation Law, corporations may not retroactively limit or eliminate indemnification rights granted under their charters or bylaws through amendments adopted after the occurrence of an act or omission to which indemnification relates, absent express language permitting this.ⁿ¹¹ The Delaware statute also protects directors, officers, employees and agents of corporations that are merged out of existence by providing that such individuals will stand in the same position with respect to the surviving corporation in a merger as they would have if the disappearing corporation had continued its separate existence.ⁿ¹²

The capacity in which an individual is acting is also relevant to whether the individual is entitled to indemnification. Under the Delaware statute, for indemnification to be available, an individual must be made (or threatened to be made) party to an action, suit or proceeding "by reason of" the individual's status as an officer, director, employee or agent of the corporation. Courts have shown some latitude in interpreting this language such that "if there is a nexus or causal connection between any of the underlying proceedings ... and one's official corporate capacity, those proceedings are 'by reason of the fact' that one was" an officer, director, employee or agent.ⁿ¹³ Accordingly, the availability of indemnification generally is not strictly limited to suits and proceedings involving actions taken in connection with the conduct of a corporate official's responsibilities on behalf of a corporation. For example, in *VonFeldt v. Stifel Financial Corporation*, the Supreme Court of Delaware refused to distinguish between various capacities in which an individual was serving at a wholly-owned subsidiary in determining that the individual was entitled to indemnification from the parent company, holding that the individual was serving at the request of the parent where the parent had elected him to the subsidiary's board of directors and calling "immaterial" the fact that the complaint named him as a defendant only in his capacities as an officer and employee and not as a director.ⁿ¹⁴

Moreover, the Supreme Court of Delaware has held that, provided the requisite nexus or causal connection is present, the motivations of the corporate official whose conduct is at issue in a proceeding are not relevant.ⁿ¹⁵ In a protracted litigation brought by Peter Tafeen, a former officer of Homestore, Inc., to compel advancement of expenses, Homestore argued that Tafeen had received \$15 million as a result of irregularities in Homestore's financial statements and that his actions were outside the scope of his official duties because they were motivated by personal greed. The Delaware Court of Chancery rejected this argument, and the Supreme Court of Delaware affirmed, holding that Tafeen was a party to the proceedings arising out of Homestore's financial statement irregularities because of his alleged role in a scheme to inflate the company's financial results while serving as an officer.ⁿ¹⁶ Accordingly, Tafeen was a party "by reason of" his status as a former officer, as required by the Delaware statute, and "without regard to [his] motivation for engaging in [the] conduct."ⁿ¹⁷

By contrast, a court found that no such nexus or causal connection was present in a proceeding arising out of the bankruptcy of Adelphia Communications Corporation in which members of the company's founding family, the Rigases, sought indemnification for defense costs incurred in connection with wire fraud charges of which they were acquitted.¹⁸ The Rigas defendants had authorized the indemnification in their capacity as directors of their privately owned cable companies, control of which had been transferred to Adelphia (the "managed entities"), and sought an injunction ordering Adelphia to pay the indemnification from these entities. The court concluded that indemnification was not available because the wire fraud charges were not brought against the Rigas defendants "by reason of" their status as directors of the managed entities or their positions with Adelphia.¹⁹ According to the court, because the wire fraud charges arose out of wire transfers made for the purpose of paying margin loans of Rigas-owned entities other than the managed entities, the charges had not been brought against them in their official capacity as directors or officers of the managed entities, and moreover, did not arise more tangentially from their roles, positions or status as such.²⁰ In reaching this conclusion, the court rejected the argument that the "by reason of" requirement had been met because the facts underlying the wire fraud charges were part of a broader conspiracy that allegedly was committed and resulted in injury to Adelphia, its investors, and banks and other creditors.²¹ Furthermore, certain types of conduct--such as sexual harassment--that are inconsistent with corporate standards or policies, and thus not explicitly or implicitly authorized by the corporation, will often be viewed as outside the scope of employment, with the result that indemnification will not be available.²²

[3] Mandatory Indemnification

Indemnification available under state indemnification statutes generally falls into two categories: mandatory indemnification and permissive indemnification. Under Section 145(c) of the Delaware General Corporation Law, indemnification of expenses for directors and officers is mandatory to the extent they are successful in defending a proceeding.²³ Accordingly, where directors and officers are defendants in a proceeding by reason of their service in such positions, to the extent they are successful, on the merits or otherwise, they are entitled to reimbursement of expenses actually and reasonably incurred in connection with mounting their defense.

The application of Section 145(c) is straightforward where a director or officer is completely victorious on the merits. In such an instance, a director or officer need only show "success" to be entitled to indemnification. Similarly, if a director or officer successfully asserts a procedural defense--such as the statute of limitations--the director or officer is entitled to indemnification as a matter of right under Section 145(c) because it mandates indemnification in the event of success "on the merits or otherwise." Absent such language, a defendant who successfully invoked the statute of limitations or another procedural defense in the early stages of litigation would be forced to undergo a trial on the merits in order to assert rights to mandatory indemnification of expenses.

Because Section 145(c) allows for partial mandatory indemnification, success in one of several related proceedings means that directors and officers are entitled to indemnification with respect to that proceeding, regardless of the outcome in other proceedings.²⁴ Likewise, where an indemnitee is successful in the defense of some, but not all, claims or counts of a single proceeding, the corporation must indemnify with respect to those claims or counts, even if the indemnitee is unsuccessful on related claims or counts.²⁵ A negotiated settlement that results in the dismissal of a case with prejudice and without any payment or assumption of liability is considered a "success" for purposes of Section 145(c),²⁶ while a dismissal of claims without prejudice is not because the claims could be litigated in another proceeding.²⁷

In contrast to Section 145(c), the Model Business Corporation Act and the indemnification statutes of those states that have followed it require that an indemnitee be "wholly successful on the merits or otherwise" to be entitled to mandatory indemnification.²⁸ The Official Comment to the Model Business Corporation Act states that, to be "wholly successful," the entire proceeding involving a director must be disposed of on a basis that does not involve a finding of liability against the director.²⁹

One court, however, has interpreted the "wholly successful" language as permitting indemnification where a result less than an acquittal or other final, favorable disposition has been obtained. In *In re Adelfia Communications Corporation*, a New York court interpreting the indemnification statutes of Georgia and North Carolina, which are both Model Act states, held that a defendant was entitled to indemnification of defense costs incurred in connection with a criminal trial where the jury hung with respect to some of the criminal counts.ⁿ³⁰ After analyzing the language of the Model Business Corporation Act and the accompanying commentary, the court concluded that the "wholly successful" requirement would be defeated by a conviction or plea, but not a hung jury.ⁿ³¹ In reaching this conclusion, the court emphasized that the Model Business Corporation Act clearly reflects a policy determination that, in criminal cases, a conviction or plea as to one count should deprive a director or officer of indemnification as to other counts.ⁿ³² The court went on to state, however, that the drafters of the Model Business Corporation Act did not plainly reject the notion that any result other than a conviction is a success.ⁿ³³ The court also emphasized that treating a hung jury as a conviction (or even as a basis for making a corporate official wait for indemnification until a decision was made on whether to retry the official) would be inconsistent with the policy in state indemnification statutes of encouraging corporate officials to serve with the assurance that they will be indemnified until they are found to have acted wrongfully.ⁿ³⁴

In practice, it is not clear whether the distinction between the Delaware General Corporation Law and the Model Business Corporation Act on the issue of partial indemnification would make much of a difference, since a director who is not "wholly successful" might still be entitled to indemnification under a corporation's charter or bylaws or an indemnification agreement if the director had acted in accordance with the statutory standard of conduct.ⁿ³⁵

[4] Permissive Indemnification and the Statutory Standard of Conduct

As discussed above, the indemnification available under state indemnification statutes generally falls into two categories: mandatory indemnification and permissive indemnification. While the limits of mandatory indemnification typically are circumscribed by statute in a fairly precise fashion, a corporation has the authority to grant permissive indemnification in a host of situations where an indemnitee is not wholly or partially successful on the merits or otherwise and thus would not be entitled to mandatory indemnification. In these situations, indemnification is left to the discretion of the corporation, subject to the satisfaction of the statutory standard of conduct. Consistent with their own interests and applicable law, corporations generally try to afford their directors and officers indemnification rights that are as broad as possible--through charter provisions, bylaws, indemnification agreements or some combination thereof--to assure these individuals that they will be protected. At the same time, however, Delaware courts have urged boards of directors to be mindful of their fiduciary duties to stockholders in adopting and reviewing indemnification and advancement protections.ⁿ³⁶ While recognizing the incentives to make these protections as broad as possible, the courts have cautioned that indemnification and advancement provisions should be "written in a manner that is fundamentally fair to the company and its stockholders."ⁿ³⁷

There are three provisions of Section 145 of the Delaware General Corporation Law that relate to permissive indemnification. For public policy reasons that will be discussed in more detail below, the Delaware General Corporation Law distinguishes between indemnification in suits brought by third parties and indemnification in suits brought by the corporation or on its behalf (such as derivative actions).

Section 145(a), which applies to third-party suits, permits a corporation to indemnify its directors, officers, employees and agents against expenses (including attorneys' fees), judgments, fines and settlement amounts incurred in any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative.ⁿ³⁸ Section 145(b), which applies to suits "by or in the right of the corporation," expressly permits indemnification of directors, officers, employees and agents only for expenses (including attorneys' fees) incurred in connection with the defense or settlement of an action or suit.ⁿ³⁹

The grant of indemnification under Sections 145(a) and (b) is not automatic. Rather, indemnification must be authorized

in the specific case upon a finding by the appropriate body that an individual is entitled to indemnification. Section 145(d) of the Delaware General Corporation Law, the third provision relevant to permissive indemnification, sets forth the procedure for determining whether an individual is entitled to indemnification under Section 145(a) or 145(b). Under Section 145(d), indemnification can be paid only "as authorized in the specific case upon a determination that indemnification ... is proper in the circumstances because the person has met the applicable standard of conduct set forth in subsections (a) and (b)" of Section 145.ⁿ⁴⁰ To satisfy the statutory standard of conduct, a person must have acted "in good faith" and "in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."ⁿ⁴¹ In addition, in any criminal action or proceeding, the person must also have had "no reasonable cause to believe the person's conduct was unlawful."ⁿ⁴²

Because indemnification must be authorized "in the specific case," it may not be made in advance pursuant to blanket authority, although directors and officers can be assured, by contract or by appropriate charter and bylaw provisions, that they will be indemnified under appropriate circumstances.ⁿ⁴³ For current directors and officers, indemnification must be authorized by one of:ⁿ⁴⁴

- (1) a majority of the directors who are not party to the suit with respect to which indemnification is sought (even if less than a quorum);
- (2) a committee of such directors (even if less than a quorum);
- (3) independent legal counsel in a written opinion; or
- (4) the corporation's stockholders.

Indemnification of employees and agents, and of former directors and officers, may be authorized by anyone that has the authority to act on behalf of the corporation for this purpose.ⁿ⁴⁵ Indemnification may also be authorized by a court, and Section 145(k) of the Delaware General Corporation Law vests exclusive jurisdiction in the Court of Chancery to hear and determine all actions for indemnification brought under Section 145 or any bylaw, agreement or otherwise.ⁿ⁴⁶

In a 2002 decision, the Supreme Court of Delaware held that, in the absence of an express demand requirement in a corporation's bylaws, there is nothing that precludes an individual from applying directly to a court to recover amounts for which indemnification is sought. That is, in the absence of a bylaw provision to the contrary, there is no requirement that an individual first apply to the corporation to have indemnification authorized through one of the four procedures (approval of the disinterested directors, a committee of disinterested directors, legal counsel, or the corporation's stockholders) outlined in Section 145(d).ⁿ⁴⁷

As long as the corporation can determine that the director has met the standard of conduct set forth in the Delaware General Corporation Law, the corporation can authorize indemnification. In addition, Section 145(a) of the Delaware General Corporation Law expressly states that "[t]he termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that" an individual did not meet the standard of conduct.ⁿ⁴⁸ Accordingly, unless the proceeding to which a director is party establishes that the director acted in bad faith or in a manner contrary to the corporation's best interests, it is possible for the corporation to authorize indemnification even if the proceeding results in a criminal conviction or judgment against the director.ⁿ⁴⁹

The availability of permissive indemnification, in Delaware and in most other jurisdictions, generally depends on the type of proceeding brought against a corporate official and the outcome of the proceeding. As discussed above, the Delaware statute distinguishes between indemnification in third-party suits (Section 145(a)) and suits brought "by or in the right of" a corporation (Section 145(b)), which include both derivative suits and direct actions by a corporation against a director or other corporate official.

In derivative suits and direct actions against corporate officials, Section 145(b) expressly authorizes indemnification only for expenses and attorneys' fees incurred in defending or settling a suit and only in circumstances where there has been no adjudication of monetary liability to the corporation.ⁿ⁵⁰ Indemnification of expenses for any claim, issue or matter as to which an individual is adjudged liable to the corporation is prohibited, absent a determination by a court that "despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper."ⁿ⁵¹ There are no definitive criteria in the Delaware General Corporation Law or the case law establishing the showing that must be made to satisfy a court that indemnification is proper.ⁿ⁵²

The rationale for the more limited indemnification rights expressly authorized in Section 145(b) is that, in a derivative suit, or a direct suit by a corporation against its officials, the corporation would not receive the benefit of judgment or settlement amounts paid to it by a corporate official if the corporation were then required to repay those amounts as indemnification. Accordingly, in actions by or in the right of a corporation, indemnification will, as a practical matter, generally be limited to expenses and attorneys' fees, when a director or officer settles or successfully defends an action, and will not extend (as in suits brought by third parties) to the amount of any judgments or settlements, although indemnification might be available with court approval or if provided for under an indemnification agreement. For example, it could be argued that, because Section 145(b) does not expressly prohibit indemnification of judgments or settlements amounts, indemnification may be provided under the nonexclusivity provision in Section 145(f) of the Delaware General Corporation Law.ⁿ⁵³

Charter or bylaw provisions, and indemnification agreements, often provide for indemnification of judgment and settlement amounts in direct and derivative suits by a corporation under the nonexclusivity provision of the Delaware General Corporation Law.ⁿ⁵⁴ Accordingly, it is possible that, with court approval, indemnification for judgment or settlement amounts would be permitted in these circumstances.ⁿ⁵⁵ If, however, an official is "adjudged liable" to the corporation, even expenses are not available, unless permitted by court order.ⁿ⁵⁶

[5] Advancement of Expenses

The right to obtain advancement of defense expenses can be critical because in many instances, the costs of defending a lawsuit are more daunting, as well as more immediate, than the ultimate threat of liability. As the Supreme Court of Delaware has observed, "[a]dvancement provides corporate officials with immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings."ⁿ⁵⁷ Most state corporation statutes specify the circumstances in which corporations may advance expenses to corporate officials to pay or reimburse reasonable expenses of defense that they incur prior to the final disposition of a proceeding. The advancement of expenses under these statutes is generally permissive, although a corporation can provide for mandatory advances in its certificate of incorporation or bylaws, or by contract. Section 145(e) of the Delaware General Corporation Law provides that a corporation may advance expenses (including attorneys' fees) incurred by a current director or officer in defending any civil, criminal, administrative or investigative action, suit or proceeding in advance of its final disposition "upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section."ⁿ⁵⁸ An undertaking is not required for employees and agents, or former directors and officers. Their expenses may be advanced "upon such terms and conditions, if any, as the corporation deems appropriate."ⁿ⁵⁹

Section 145(e) does not require that an undertaking to repay amounts advanced be secured, nor is the availability of advancement contingent upon an individual's financial ability to repay the corporation, although a corporation may require, in its bylaws or by contract, that a recipient of advances furnish security or demonstrate adequate financial resources.ⁿ⁶⁰ The absence of such conditions in the statute is consistent with the purpose underlying Section 145(e), which is to: "encourag[e] qualified persons to become or remain as directors of Delaware corporations, by assuring

them, *ex ante*, that they may resist lawsuits that they consider meritless, free of the burden of financing (at least initially) their own legal defense."ⁿ⁶¹ However, in a series of cases--most notably, the protracted litigation involving Homestore, Inc. and a former officer's right to advancement of expenses--the Delaware courts have increasingly emphasized that this goal must be balanced against "the obligation to ensure that advancement and indemnification [protections] are written in a manner that is fundamentally fair to the company and its stockholders."ⁿ⁶² In this regard, the Delaware Court of Chancery has stated that Section 145(e) merely sets forth the "bare minimum requirements" with respect to advancements, but leaves to the corporation itself (in its organizational documents and/or indemnification agreements) the determination as to "the *proper* balance between seeking able persons to serve as directors and officers and safeguarding the expenses advanced by the company, and thus the corporation's stockholders."ⁿ⁶³ Accordingly, the Delaware courts have rejected companies' attempts to argue "in broad-brush fashion" that the goal of attracting qualified directors and officers necessitates extensive advancement and indemnification rights, noting that this argument "falls woefully short of explaining the basis for exempting from *any* form of secured undertaking corporate [officials] who have been compensated at levels that would make it relatively simple to provide secured undertakings for the advancement of fees and costs."ⁿ⁶⁴

At the same time, however, the Delaware courts have made clear, in the *Homestore* litigation and subsequent cases, that they will enforce broad advancement provisions as written.ⁿ⁶⁵ Accordingly, the Delaware courts have not permitted companies "to escape the consequences of their own contractual freedom":ⁿ⁶⁶

Regretting the broad grant of mandatory advancement they forged on a clear day, [companies] seek to have the judiciary ignore the plain language of their contracts and generate an after-the-fact judicial contract that reflects their current preference. But is not the job of a court to relieve sophisticated parties of the burdens of contracts they wish they had drafted differently but in fact did not. Rather, it is the court's job to enforce the clear terms of contracts.

Instead, the Delaware courts have "emphasize[d] the unambiguous fact that corporations that voluntarily extend to their officers and directors the right to indemnification and advancement under *8 Del. C. § 145* have a duty to fulfill their obligations under such provisions with good faith and dispatch."ⁿ⁶⁷

In the *Homestore* litigation,ⁿ⁶⁸ a lengthy proceeding in which former officer Peter Tafeen sought to compel advancement of legal expenses, the Delaware Court of Chancery rejected the argument that it would undermine the policy of encouraging individuals to serve as directors and officers to allow an "unclean hands" defense to Tafeen's request for advancement where he had allegedly sheltered assets to evade a potential obligation to repay advanced funds.ⁿ⁶⁹ In the course of the advancement proceeding, Homestore argued that Tafeen had taken affirmative actions to shelter his assets in order to avoid having to reimburse the corporation if it were ultimately determined that he was not entitled to be indemnified. Therefore, Homestore argued, Tafeen had acted in bad faith and his claim for advancement should be barred by the doctrine of "unclean hands" and his breach of an implied covenant of good faith and fair dealing. In ordering a trial to resolve factual issues relating to Tafeen's conduct, the court concluded that a corporate official would "not be permitted to use the *statute itself* [Section 145(e)] after taking improper actions at the expense of the corporation's stockholders."ⁿ⁷⁰ Following a trial, the Delaware Court of Chancery concluded that Homestore had not met its burden of establishing that Tafeen had been engaged in a deliberate effort to shelter assets from Homestore.ⁿ⁷¹ The court also noted that an inability to repay is not a disqualification from advancement and refused to interpret Homestore's broad advancement bylaw as obligating Tafeen to maintain and demonstrate a financial ability to repay when the bylaw did not require a secured undertaking or any showing of ability to repay.ⁿ⁷² The court subsequently entered a final order directing Homestore to pay legal fees and expenses that Tafeen had previously incurred (with interest) and to advance his legal fees and expenses going forward.ⁿ⁷³ The Court of Chancery later denied Homestore's request for a stay of the court's order, and the Supreme Court of Delaware affirmed.ⁿ⁷⁴ In denying Homestore's request, the Court of Chancery concluded, among other things, that granting the stay would violate Delaware's public policy of encouraging individuals to serve as directors and officers by providing them with indemnification and advancement rights and Delaware's public policy of resolving advancement issues quickly.ⁿ⁷⁵ For

this reason, Section 145(k) of the Delaware General Corporation Law provides for expedited proceedings to determine advancement rights. These proceedings are "summary" in nature, meaning that they are generally limited to determining whether the relevant governing documents (charter, bylaws, indemnification agreements) provide a right to advancement.ⁿ⁷⁶ After noting that "[c]learly, to be of any value to the executive or director, advancement must be made promptly, otherwise its benefit is forever lost,"ⁿ⁷⁷ the Court of Chancery concluded that granting Homestore's request for a stay:ⁿ⁷⁸

would allow it to continue to be derelict in its contractual protection of its directors/officers, and that would force its directors/officers to compromise their litigations in the face of cost concerns, a result that is clearly against Delaware's policy of resolving advancement issues as quickly as possible.

The Supreme Court of Delaware subsequently affirmed the holdings of the Delaware Court of Chancery in the *Homestore* litigation, including the Court of Chancery's conclusions that Tafeen's actions did not rise to the level of "unclean hands" or a breach of the implied covenant of good faith and fair dealing that would relieve Homestore of its obligation to advance his expenses.ⁿ⁷⁹ Shortly after the Supreme Court of Delaware issued its decision, Homestore and Tafeen entered into a settlement agreement requiring Homestore to reimburse Tafeen up to a maximum of almost \$12 million, including approximately \$6.5 million that had already been advanced through January 2006. Under the settlement agreement, Homestore also agreed not to seek repayment of any funds advanced to Tafeen if it should subsequently be determined that Tafeen is not entitled to indemnification.ⁿ⁸⁰ Eight days after the announcement of the settlement, Tafeen pleaded guilty to one count of securities fraud under a plea agreement stating that he had received \$6.4 million from insider trading in Homestore's stock.ⁿ⁸¹

In *Barrett v. American Country Holdings, Inc.*,ⁿ⁸² the Delaware Court of Chancery concluded that a company's directors and officers had a clear right to advancement under the company's certificate of incorporation and sharply criticized the company's attempts to extract a settlement from the former directors and officers by arguing that they had forfeited that right as a result of refusing to settle the company's claims against them. The Court of Chancery upheld the advancement rights of the former directors and officers, characterizing the company's arguments to the contrary as "outlandish," "baseless" and "illogical."ⁿ⁸³ In *Barrett*, plaintiffs were former directors and officers of American Country Holdings, Inc., who were suing for enforcement of their advancement rights in connection with litigation brought against them by American Country arising out of the company's acquisition by Kingsway Financial Services, Inc. The basic contention was that the former directors and officers had misled Kingsway concerning the true financial condition of American Country. The D&O insurer had been advancing fees for the defense of that action, but the policy limits were about to be exhausted, so the directors and officers asked the company to confirm that they were entitled to advancement of their legal fees going forward. The company failed to respond, and the directors and officers sued. Despite clear terms in its certificate of incorporation requiring advancement, the company took the position that the directors and officers had forfeited their right to advancement by unreasonably rejecting the company's offers to settle the litigation against them.

The Delaware Court of Chancery rejected the company's arguments, describing the company's position as "truly astounding," and "stunning for its lack of basis in law, logic or common sense."ⁿ⁸⁴ The company's suit against the directors and officers entitled them to "put up a vigorous defense," and to have the company honor its contractual advancement obligations in doing so. According to the court, an "important part of the policy rationale supporting indemnification and advancement is that corporate officials should be able to defend not only their pocketbooks, but also their good names."ⁿ⁸⁵ The court made clear that "a defendant who faces claims of official wrongdoing and who is owed advancement rights is entitled to have those rights honored precisely so that she can defend her good name and personal wealth."ⁿ⁸⁶

In concluding that the directors and officers had a clear right to advancement, the court noted, as it has in previous cases, that if companies wish to avoid advancing expenses in certain circumstances, such as where they believe an individual may have engaged in misconduct, then they should draft their advancement provisions differently:

One wishes that the tsunami of regret that swept over corporate America regarding mandatory advancement contracts would have been followed by the more careful tailoring of advancement provisions, with a diminishment (especially as to officers) of the mandatory term that seems to so bother directors faced with the responsibility of actually ensuring that the corporation honors its contractual duties once a (typically) former officer is sued or prosecuted for fraud or other serious wrongdoing. Although it is uncomfortable to cause the corporation to advance millions in fees to a former officer the current board believes engaged in serious misconduct, it does stockholders no service for a board to refuse to do so when the advancement obligation is clear. If the directors in such a situation truly wish to serve the stockholders, they should fix what they can by revising the corporation's advancement obligations on a going-forward basis. To breach a contract because you do not like its terms while refusing to change it when you have the authority to do so is hard to explain as an act of appropriate fiduciary fortitude.ⁿ⁸⁷

The Delaware statute has also taken what one pair of commentators calls "a realistic approach" of not conditioning eligibility for advances on compliance with a particular standard of conduct, in recognition of the fact that the propriety of an individual's conduct may not be ascertainable in the early stages of litigation.ⁿ⁸⁸ Accordingly, even if a complaint against a corporate official alleges facts that, if true, would prohibit indemnification, to be entitled to advances the official need only provide an undertaking to return any amounts advanced if it is later determined that he or she is not entitled to indemnification because of a failure to meet the statutory standard of conduct. In fact, the Delaware courts have observed that "it is in those very cases" where a corporate official is accused of serious wrongdoing "that the right to advancement attaches most strongly."ⁿ⁸⁹ In this regard, the Supreme Court of Delaware has observed that the public policy behind the Delaware advancement statute "will only be achieved if the promissory terms of advancement contracts are enforced by courts even when corporate officials ... are accused of serious misconduct."ⁿ⁹⁰

Accordingly, even where a corporate officer has been convicted of criminal charges and sentenced but has time remaining to appeal, or has admitted wrongdoing and pled guilty to criminal charges the Delaware Court of Chancery has held that the officer is entitled to continue to receive advancement of his legal expenses under a typical, broad-based mandatory advancement provision.ⁿ⁹¹

Sun-Times Media Group, Inc. v. Conrad M. Black, et al. involved four former officers of the company who had been convicted of criminal charges at the trial court level and had been sentenced. After their sentencing, Sun-Times informed the former officers that it would no longer advance expenses to them. Like many public companies, Sun-Times had an advancement provision in its bylaws that mirrored the language in Section 145(e) of the Delaware General Corporation Law, providing that directors and officers were entitled to have their expenses paid by Sun-Times "in advance of the final disposition" of an action, suit or proceeding, subject to an agreement of the director or officer to repay any advances "if it shall ultimately be determined that he is not entitled to be indemnified."ⁿ⁹² At the time the Delaware Court of Chancery heard the case, the U.S. Court of Appeals for the Seventh Circuit had affirmed the convictions of the former officers, but the time period for filing a petition for certiorari with the U.S. Supreme Court had not yet expired.ⁿ⁹³ The court held that the "final disposition" of an action, suit or proceeding means a "final, non-appealable conclusion of that proceeding" and that, because appellate proceedings were not yet concluded, Sun-Times remained obligated to advance expenses to its former officers despite their conviction and sentencing.ⁿ⁹⁴ The court based its holding on the "final disposition" language of the Sun-Times bylaws and the corresponding provision of Section 145(e) of the Delaware General Corporation Law, the Delaware public policy favoring advancement of expenses and the practical difficulties that would arise if each successive stage of a legal action were considered a separate proceeding in which a "final disposition" could occur.

The *Sun-Times* opinion discussed at some length the Delaware Court of Chancery's earlier decision in *Bergonzi v. Rite Aid Corporation*.ⁿ⁹⁵ In *Bergonzi*, the court held that Rite Aid remained obligated to continue advancing expenses to its former Chief Financial Officer, Frank Bergonzi, who had pled guilty to participating in a criminal conspiracy to defraud the company and admitted under oath to deliberate falsification of the company's financial statements and to receiving a

fraudulently backdated employment agreement that purported to grant him millions of dollars. Following the guilty plea, Rite Aid notified Bergonzi that it would no longer advance the costs of his defense. The advancement provision in Rite Aid's certificate of incorporation was identical in substance to the provision in the *Sun-Times* bylaws. The Delaware Court of Chancery concluded that even though Bergonzi had pled guilty, his proceedings had not reached a "final disposition" because he was required to testify in a related proceeding pursuant to his plea agreement, and this testimony would impact whether he received a favorable sentencing recommendation.ⁿ⁹⁶ Accordingly, the court concluded that Bergonzi continued to have an enforceable right to advancement and that Rite Aid was required to continue advancing his expenses.ⁿ⁹⁷ The court also rejected the argument that the guilty plea was an "ultimate determination" that Bergonzi was not entitled to indemnification, and therefore was no longer entitled to receive advances.ⁿ⁹⁸ In reaching this conclusion, the court cited language in the undertaking Bergonzi had provided to Rite Aid requiring the return of advances in the event of an ultimate determination by a court in a final judgment, which had not occurred.ⁿ⁹⁹ The court also cited language in Rite Aid's certificate of incorporation establishing that, in proceedings to enforce rights to indemnification, *but not* advancements, "[i]t shall be a defense" that an individual has not met the statutory standard of conduct that makes indemnification permissible under Delaware law.ⁿ¹⁰⁰ According to the court, the plain language of the certificate of incorporation precluded RiteAid from asserting that Bergonzi had not met the standard of conduct as a defense to Bergonzi's claim for advances.ⁿ¹⁰¹

In May 2007, former Qwest Communications International Inc. Chairman and CEO Joseph Nacchio filed a lawsuit in the Delaware Court of Chancery seeking payment of his legal bills.ⁿ¹⁰² In addition to facing criminal insider trading charges, Nacchio was named in several stockholder suits and was charged with civil fraud by the SEC stemming from an accounting scandal. Qwest had been advancing Nacchio's legal fees and expenses since early 2006. However, following his April 2007 insider trading conviction, Nacchio claimed that Qwest had threatened to discontinue these payments. Though the company had not officially refused to continue its payments, Nacchio sued to enforce provisions of his employment agreement and resignation agreement that provided for mandatory advancement of legal expenses. He argued that Qwest was bound by Delaware law to pay all his legal bills unless and until there was a final determination that he had been dishonest and that a delay in payment pending Qwest's review of its obligations would jeopardize his defense. In July 2007, Nacchio and Qwest reached a settlement whereby Qwest agreed to pay all past legal bills and all future bills related to the civil cases but Nacchio would be responsible for the expenses associated with the appeal of his criminal insider trading conviction.ⁿ¹⁰³ Nacchio's conviction for insider trading was overturned and a new trial was ordered by a three-judge panel of the U.S. Court of Appeals for the 10th Circuit in March 2008.ⁿ¹⁰⁴ Then, in February 2009, the full 10th Circuit reinstated Nacchio's conviction.ⁿ¹⁰⁵ Nacchio filed a petition with the U.S. Supreme Court in March 2009.ⁿ¹⁰⁶ Qwest has indicated that it will wait until the end of the appeals process before deciding whether to try to recover the legal fees that it has advanced to Nacchio.ⁿ¹⁰⁷ The history of these insider trading proceedings illustrates precisely the type of practical difficulties that would arise if each successive stage of a legal action were considered a separate proceeding in which a "final disposition" could occur--difficulties that the Delaware Court of Chancery cited in the *Sun-Times* case (discussed above) in holding that a "final disposition" means the "final, non-appealable conclusion of [a] proceeding."

In contrast to the Delaware statute, the Model Business Corporation Act contains a good faith requirement as a condition of receiving an advancements of expenses. Section 8.53(a) of the Model Business Corporation Act requires a written affirmation by a director stating the director's good faith belief that he or she has met the applicable standard of conduct (or that the proceeding involves conduct for which liability has been eliminated under an exculpatory charter provision),ⁿ¹⁰⁸ along with an undertaking to repay any funds advanced if the director is not entitled to mandatory indemnification and it is ultimately determined that the director did not meet the standard of conduct.ⁿ¹⁰⁹ The practical result of the good faith requirement is that, under the Model Business Corporation Act, if a corporation were to disagree with a director's good faith belief regarding satisfaction of the applicable standard of conduct, it could be necessary for the director to litigate to demonstrate an entitlement to advances even if the corporation has provided for mandatory advancements in its certificate of incorporation or bylaws or by contract. Under Delaware law, if advancements are mandatory, that is the end of the inquiry.

To protect their officers and directors, many corporations mandate advancement of expenses through provisions in the certificate of incorporation, bylaws, or indemnification agreements. To the extent that advancement is not mandatory, and is left to the discretion of the board of directors, the decision to advance expenses is a business judgment that must be made consistent with the duties of care and loyalty.ⁿ¹¹⁰

In considering whether to authorize advances, directors must determine whether the undertakings provided by those seeking advances are sufficient, in all of the circumstances, to protect the corporation's interests in repayment and whether advancement would, on balance, be likely to promote the corporation's interests.ⁿ¹¹¹

The results in the *Sun-Times*, *Bergonzi* and *Homestore* cases, as well as the Qwest litigation, illustrate the importance of giving careful consideration to the scope of the advancement, and indemnification, rights that a corporation provides to its directors and officers. In this regard, boards should consider whether, and to whom, mandatory advancement rights should be granted and, to the extent mandatory rights are granted, whether limitations on those rights are appropriate. These limitations might include requiring a secured undertaking of the obligation to repay, permitting advances in third-party suits but not in suits brought by or on behalf of the company or by a corporate official against the company, or granting discretion to the board of directors or another decision-maker to curtail the advancement of expenses to directors and/or officers if a determination is made at some point in a legal proceeding, based on the facts and circumstances, that an individual failed to meet the statutory standard of conduct.ⁿ¹¹² A small number of companies have taken this latter approach by adopting broad-based, mandatory advancement rights in their charters and/or bylaws, but making these rights subject to limitations that are designed to protect against the possibility of having to advance expenses to so-called "bad actors."ⁿ¹¹³

To the extent the corporation intends to limit advancement rights, the preferred approach is to spell out any limitations clearly.ⁿ¹¹⁴ However, the Delaware Court of Chancery's 2007 decision in *Thompson v. The Williams Cos.*ⁿ¹¹⁵ suggests that a company need not always articulate in advance the specific conditions that it intends to place on advancement rights. Instead, it is sufficient for a company to provide "fair notice" that it may impose limits on those rights. *Thompson* involved an advancement bylaw stating that expenses incurred by employees and agents "shall be paid upon such terms and conditions, if any, as the Board of Directors deems appropriate."ⁿ¹¹⁶ The Delaware Court of Chancery rejected the argument made by Thompson, an employee, that the company was not entitled under the language of the bylaw to condition advancement of expenses on Thompson's provision of an undertaking and full security for the amounts advanced. In doing so, the Court of Chancery concluded that the advancement bylaw "expressly sets forth the right of the board to impose terms and conditions, and it gives fair notice to anyone hoping to rely on that provision that prerequisites to a grant of advancement might be demanded."ⁿ¹¹⁷ Given the bylaw language, the key issue for the Court of Chancery was whether the conditions set by the company were "appropriate," a term that was "best understood as enabling the board to condition a grant of advancement on terms and conditions that rational directors might believe necessary to protect [the company's] legitimate interests."ⁿ¹¹⁸

Another case reflecting that Delaware courts will enforce obligations to advance expenses as written--although one that involved an unfavorable outcome for a former director seeking to enforce his advancement rights--is the Delaware Court of Chancery's 2008 decision in *Schoon v. Troy Corp.*ⁿ¹¹⁹ In *Schoon*, the Court of Chancery held that a former director was not entitled to advancement where, subsequent to the director's departure from the company's board, the company revised its bylaws to eliminate advancement rights for former directors. The former director had resigned from the board in 2005. At the time of his resignation, Troy Corporation's bylaws expressly provided for indemnification and advancement rights to former directors. Thereafter, however, Troy's board amended the bylaw granting advancement rights to remove the word "former." Then, in January 2006, Troy asserted breach of fiduciary duty claims against the former director, who sought a court ruling that he was entitled to advancement.

The Delaware Court of Chancery strictly construed Troy's bylaws and rejected the former director's argument that his advancement rights became vested at the time he took office as a director and could not be unilaterally changed thereafter. Distinguishing an earlier Delaware decision in *Salaman v. National Media Corp.*,ⁿ¹²⁰ the court concluded

that the right to advancement only becomes vested when litigation is actually filed. In *Schoon*, Troy brought suit against the former director after he left the board and after the board had amended the bylaws to eliminate advancement for former directors.ⁿ¹²¹ Moreover, although Troy conceded that its bylaws, as amended, allowed former officers to be *indemnified*, the court read the bylaws to distinguish between former directors' rights to indemnification and to advancement. In the latter case, the bylaw change following the former director's departure from the board clearly and unambiguously eliminated the right of advancement to former directors. The *Schoon* decision prompted numerous companies to revise their indemnification bylaws to clarify that rights to indemnification and advancement vest at the commencement of an individual's service as a director or officer or to enter into stand-alone indemnification agreements to provide their directors and officers with contractual rights. However, this proved to be unnecessary because, in 2009, the Delaware legislature adopted an amendment to Section 145(f) of the Delaware General Corporation Law in response to the *Schoon* decision that limits the ability of corporations to amend indemnification and advancement provisions retroactively. Under amended Section 145(f), rights to indemnification and advancement of expenses arising under a corporation's charter or bylaws cannot be eliminated or impaired by an amendment adopted after the occurrence of the act or omission to which the indemnification or advancement of expenses relates, unless the charter or bylaw provision in effect at the time of the act or omission expressly permits this.ⁿ¹²²

Another development suggesting that courts will respect advancement obligations in the context of criminal prosecutions is the 2008 ruling by the U.S. Court of Appeals for the Second Circuit in *United States v. Stein*.ⁿ¹²³ In that case, the Second Circuit upheld the dismissal by the U.S. District Court for the Southern District of New York of an indictment against 13 former partners and employees of KPMG LLP and affirmed the lower court's holding that the U.S. government had deprived the individuals of their *Sixth Amendment* right to counsel by causing KPMG to impose conditions on the advancement of legal fees to the individuals, cap their fees, and ultimately stop advancing fees altogether.

The KPMG case involved the now-superseded "Thompson memo" issued by former Deputy Attorney General Larry Thompson in 2003 following the unprecedented wave of corporate scandals that began with the collapse of Enron Corp.ⁿ¹²⁴ The Thompson memo set forth factors that federal prosecutors were required to consider in assessing an organization's cooperation for purposes of deciding whether to indict the organization. These included "whether the corporation appears to be protecting its culpable employees and agents" through, among other things, "the advancing of attorneys fees," although the advancement of legal fees would not be viewed as a failure to cooperate where required by state law.ⁿ¹²⁵ Not long after the lower court decision in the KPMG case, in December 2006, Deputy Attorney General Paul J. McNulty announced the release of revised corporate charging guidelines for federal prosecutors. These guidelines superseded the Thompson memo. The so-called "McNulty memo" instructed prosecutors that they generally could not consider a corporation's advancement of attorney's fees when deciding whether to charge the corporation, but there was an exception for instances where advancement was intended to impede the government's investigation.ⁿ¹²⁶ On the same day that the Second Circuit issued its decision in the KPMG case, the Department of Justice announced that it was changing its policy in this area. The August 2008 "Filip memo" explicitly states that prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees in evaluating its cooperation with a government investigation and that they may not ask a corporation to refrain from advancing or reimbursing attorneys' fees.ⁿ¹²⁷ The KPMG decision and the Filip memo provide some assurance to directors and officers of corporations that have undertaken the obligation to provide mandatory advancement and indemnification that this obligation will be protected in the event of a government investigation.

Where a corporation does intend to make advances mandatory, this intention should be stated expressly in the corporation's certificate of incorporation or bylaws, or in the relevant indemnification agreement and addressed separate and apart from rights to indemnification. The Delaware courts have construed provisions that mandate indemnification, without making specific reference to advances, as not including advances. In *Advanced Mining Systems, Inc. v. Fricke*, the Delaware Court of Chancery considered whether a bylaw provision provided for mandatory advancement of expenses where the provision required that the corporation "indemnify" its directors, officers, employees and agents to the fullest extent permitted by the Delaware General Corporation Law.ⁿ¹²⁸ The court held that the provision did not, on

the grounds that indemnification and advances implicate distinct corporate interests and different types of rights.ⁿ¹²⁹ In the court's view, because the decision to advance expenses is subject to an undertaking to repay those amounts if it is ultimately determined that the recipient is not entitled to indemnification, it "is essentially simply a decision to advance credit."ⁿ¹³⁰ The court concluded that interpreting the bylaw provision to mandate advances would deprive the board of its function under Section 145(e) to evaluate the corporation's interest with respect to the advancement of expenses.ⁿ¹³¹

By contrast, under the Model Business Corporation Act, the intention to provide mandatory advancement of expenses is implied in any provision that obligates a corporation to provide indemnification to the fullest extent permitted by law, unless the provision expressly states otherwise.ⁿ¹³² As with advances, corporations that intend to authorize payment of "fees on fees"--that is, fees incurred to enforce rights to advances--should explicitly provide for this in their organizational documents or indemnification agreements, as discussed in more detail below.ⁿ¹³³

While Delaware case law suggests that agreements to advance legal expenses will be enforced as written, there are exceptions. In October 2006, the First Circuit Court of Appeals, applying Delaware law, permitted Corning, Inc. to condition advancement of expenses to a director on his agreement to repay the advances on terms different from--and arguably less advantageous to the director than--those provided for in the company's bylaws and the director's indemnification agreement.ⁿ¹³⁴ Happ was a director of Galileo, Inc., a Delaware corporation, and the SEC charged him with insider trading. At the time Happ sought advances to cover his defense costs, Galileo had been acquired by Corning.ⁿ¹³⁵ Galileo's bylaws and Happ's indemnification agreement provided that Happ was entitled to indemnification if he "acted in good faith and in a manner that he reasonably believed to be in or not opposed to the best interests" of Galileo, and that Galileo would advance Happ's defense costs so long as he executed an undertaking to repay the advances "if it shall ultimately be determined that [he] is not entitled to be indemnified."ⁿ¹³⁶ When Happ sought advances, Corning refused until Happ agreed to repay in the event he lost the insider trading enforcement action.ⁿ¹³⁷

Happ and Corning continued to have disputes over advances, and Happ sued Corning. Happ lost the insider trading enforcement action and Corning then counterclaimed, seeking repayment of the advances. Happ claimed that his undertaking had been obtained through duress and that his obligation to repay should be governed by the original terms of the bylaws and indemnification agreement, rather than by the differently phrased terms of the undertaking. The First Circuit disagreed, concluding first that Corning's negotiation of the terms of Happ's undertaking to repay was "commercial bargaining," not wrongful duress. The Circuit Court then determined that it was questionable whether Happ or any director found liable for insider trading could ever be entitled to indemnification, even under the language of the original bylaws and indemnification agreement. Finally, the court found that it was not unreasonable for Corning to insist on renegotiating the standard for Happ's obligation to repay, given that the bylaws and indemnification agreement did not state precisely how the undertaking to repay advances should be phrased or whether the company had any right to insist on spelling out the circumstances in which Happ would not be entitled to indemnification.ⁿ¹³⁸ The First Circuit ultimately did not settle the issues of whether, how, and by how much companies may narrow the scope of their indemnification agreements with their directors after those directors have been sued or are under investigation. It should also be noted that the director's difficulties in *Happ* followed a change of control.

As the *Happ* case demonstrates, when drafting undertakings made in connection with an agreement to advance legal fees, it is unclear the extent to which a corporation will be able to limit its advancement obligations after the fact by demanding more narrowly-drafted language in an undertaking than that contained in the original indemnification provision. Interestingly, the First Circuit acknowledged that if, instead of signing the undertaking, Happ had challenged Corning's insistence on renegotiating the terms of his obligations to repay in a summary proceeding in Delaware, he might have prevailed. Therefore, it is possible that Happ could have held Corning to an undertaking that was consistent with the language of the bylaws and indemnification agreement.

[6] Sarbanes-Oxley Act Loan Prohibition

Since the passage of the Sarbanes-Oxley Act, questions have arisen about the status of advances. Section 402 of the Sarbanes-Oxley Act makes it unlawful for public companies to extend credit "in the form of a personal loan to or for any director or executive officer."ⁿ¹³⁹ As some practitioners have noted, this provision calls into question whether advancement of defense costs that have to be repaid to the corporation constitute a personal loan.ⁿ¹⁴⁰ In a 2004 decision, the Delaware Court of Chancery bypassed this issue by concluding that Section 402 applies only to current directors and officers, and therefore was not relevant in a proceeding involving advances to a former officer.ⁿ¹⁴¹ The same issue arose in a 2006 case in the U.S. District Court for the Southern District of New York, *Envirokare Tech, Inc. v. Pappas*, but instead of relying on the reasoning that Section 402 does not prohibit loans to *former* officers, the court held that an advancement of defense costs did not constitute a "personal loan."ⁿ¹⁴²

The result in *Envirokare* is consistent with a position paper issued in October 2002 by a consortium of 25 major U.S. law firms that addressed interpretive issues under Section 402, including the status of advances to officers and directors.ⁿ¹⁴³ The position paper offers several arguments as to why advances should not be considered prohibited personal loans under Section 402. First, the paper argues that there is a well-developed and longstanding state policy interest in providing advances that is unrelated to the types of insider conflicts of interest at which Section 402 is directed, and neither the text of the statutory provision nor the limited legislative history of the Sarbanes-Oxley Act suggests that Congress intended to limit historic state authority in this area.ⁿ¹⁴⁴ Second, the prospect of indemnification becoming unavailable could significantly discourage service as an executive officer or director, to the detriment of public companies.ⁿ¹⁴⁵

The paper also makes several arguments based on the language of Section 402. For example, it takes the position that advances are not "in the form of a ... loan" because at the time a commitment to pay advances arises (for example, at the outset of service to the corporation), and presumably even at the time advancement occurs, the recipient of the advances is only contingently required to repay the issuer and the contingency makes the likelihood of repayment reasonably uncertain.ⁿ¹⁴⁶ Similarly, another authority has argued that the unconditional obligation to repay "is the most central feature of a loan."ⁿ¹⁴⁷ Accordingly, because a director or officer is not obligated to repay an advance unless, at a later date, "a contingency of reasonable uncertainty occurs," this contingency "distinguishes ... advances from personal loans and should remove them from Section 402."ⁿ¹⁴⁸

In addition, the law firm position paper argues that an advancement of expenses is not "personal" because the expenses are incurred in connection with services to a company that constitute a business purpose regardless of whether ultimately these amounts need to be repaid. According to the position paper, the repayment obligation contemplated by the arrangement and triggered by external events does not change the business nature of the arrangement.ⁿ¹⁴⁹

In the absence of further clarification, the impact of Section 402 on the viability of advances remains uncertain, although corporations have continued to advance expenses to their directors and officers since the passage of the Sarbanes-Oxley Act. In view of the uncertainty about Section 402, some public companies have moved to revise language in their organizational documents and indemnification agreements to characterize "advances" as "payments" and to indicate that such payments will not be deemed to be loans, although the presence of such language may not be dispositive of the status of advances under Section 402.

[7] Statutory Nonexclusivity Provisions

The corporation laws of most states, including Delaware, contain what are known as "nonexclusivity" provisions, which state that statutory rights to indemnification and advancement are not exclusive of other rights that may be granted pursuant to a corporation's charter or bylaws, by contract, or otherwise.ⁿ¹⁵⁰ Section 145(f) of the Delaware General Corporation Law, for example, provides that:ⁿ¹⁵¹

The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking

indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office.

A nonexclusivity provision like Section 145(f) provides authority for charter provisions, bylaws, and indemnification agreements that expand upon the indemnification rights expressly granted by statute. Although there has been little authority under Delaware law clarifying the precise scope of rights that can be granted under Section 145(f), these rights are generally thought to be subject to public policy limitations and to the substantive limits of the Delaware General Corporation Law (such as the limitations on indemnification in derivative suits under Section 145(b)).¹⁵² The Supreme Court of Delaware, for example, has taken the position that the scope of indemnification rights granted to an individual by contract cannot be broader than the indemnification rights granted by statute.¹⁵³ Accordingly, if Section 145 were amended to curtail statutory indemnification rights, "the fact that [a director's] rights were also secured by contract would be of little use to him. Private parties may not circumvent the legislative will simply by agreeing to do so."¹⁵⁴

A Second Circuit case interpreting Section 145 is consistent with this position. In *Waltuch v. ContiCommodity Services, Inc.*, the Second Circuit affirmed a lower court holding that Section 145(f) cannot be used to circumvent the good faith requirement embodied in Section 145(a) of the Delaware General Corporation Law.¹⁵⁵ The plaintiff in *Waltuch*, a corporate officer, sought indemnification for defense costs in reliance on a provision in the certificate of incorporation that provided for mandatory indemnification but did not expressly require good faith as a condition of indemnification. In reliance on the nonexclusivity provision in Section 145(f), plaintiff *Waltuch* argued that the statutory good faith requirement could not be read as a limitation of the additional rights conferred under the certificate of incorporation and that Section 145(f) allows corporations to indemnify their officials in a manner broader than that set out in Section 145(a). Both the lower court and the Second Circuit disagreed, concluding that:¹⁵⁶

Under § 145(f), a corporation may provide indemnification rights that go 'beyond' the rights provided by § 145(a) and the other substantive subsections of § 145. At the same time, any such indemnification rights provided by a corporation must be 'consistent with' the substantive provisions of § 145, including § 145(a).

The Second Circuit reasoned that the good faith requirement in Section 145(a) "must mean that there is *no power* to indemnify" if a corporate officer did not act in good faith because otherwise the good faith clause would have no meaning and corporations could indemnify whomever and however they wanted regardless of any limitations in the statutory provision.¹⁵⁷ Based on this reasoning, the court concluded that the provision in the certificate of incorporation, which would have required indemnification of *Waltuch* even if he had acted in bad faith, was inconsistent with Section 145(a) and exceeded the scope of a Delaware corporation's powers to indemnify.¹⁵⁸

Delaware courts have subsequently adopted the position taken by the Second Circuit in *Waltuch*.¹⁵⁹ Accordingly, although indemnification rights granted under Section 145(f) can be broader than those expressly provided for under other parts of Section 145, the grant of rights may not permit indemnification in a manner that is inconsistent with the substantive provisions of Section 145.¹⁶⁰

[8] Charter and Bylaw Provisions

As permitted by the nonexclusivity provisions of state corporate law, many corporations have adopted charter and bylaw provisions addressing indemnification. These provisions can afford directors and officers increased protection by granting them substantive rights in addition to those expressly provided for by state indemnification statutes and by supplementing the coverage available under D&O insurance policies. Charter and bylaw provisions are also used to clarify the extent of the indemnification rights available in particular circumstances and to establish procedures and presumptions that make indemnification more favorable to directors, officers and other corporate officials. Appendix

5-A to this chapter contains a sample exculpatory charter provision for a Delaware company and Appendix 5-B contains a sample indemnification bylaw provision for a publicly held Delaware company.

The advantages of addressing indemnification in the certificate of incorporation rather than the bylaws are comparatively few, and it is more common to see detailed indemnification provisions in a corporation's bylaws. The primary benefit of a charter provision lies in the fact that the certificate of incorporation generally may be amended only with stockholder approval. This, in turn, can protect against changes in indemnification rights in the event of a change in the majority of the board of directors. Another benefit of a charter provision--also related to the requirement of stockholder approval--is that stockholder approval often lends a degree of corporate authority to indemnification provisions. Amendment of an indemnification bylaw, however, can also be made subject to approval of a corporation's stockholders. Moreover, if there are concerns about the repeal or amendment of charter or bylaw provisions establishing rights to indemnification, the requirement of stockholder approval can be strengthened by conditioning changes to those provisions on receipt of a super-majority vote (*i.e.*, two-thirds or three quarters of outstanding shares). It should be noted that some companies have moved to eliminate super-majority vote provisions in recent years in response to stockholder proposals.

Although bylaws can be adopted by a corporation's board of directors as well as its stockholders, a corporation could voluntarily submit indemnification bylaws to its stockholders for approval to lend those provisions the same added authority as a charter amendment. In addition, obtaining stockholder approval of an indemnification bylaw could reduce the likelihood that the directors who approve the bylaw will be deemed "interested" in the transaction and that it could be successfully challenged as a conflict of interest. On the other hand, a requirement of stockholder approval can make changing indemnification provisions more difficult and expensive. Moreover, in the post-Enron environment, where the actions of corporate officials are subject to increased scrutiny, corporations may be hesitant to seek stockholder approval of bylaw provisions establishing or enhancing indemnification rights.¹⁶¹ However, if a corporation's stockholders have previously approved an indemnification bylaw, care should be taken to ensure that any subsequent amendments by the board of directors do not detract from stockholder-approved rights.

Many corporations that take the approach of adopting a detailed indemnification bylaw nevertheless find it useful to include a general declaration of their commitment to indemnify corporate officials in the certificate of incorporation. To the extent that a corporation addresses indemnification in both its charter and bylaws, it is critical for the provisions in the two documents to be consistent. In addition, in situations where charter or bylaw provisions are approved by a corporation's stockholders, the provisions should authorize the board to make further amendments and to implement the provisions through bylaws, agreements, and insurance, subject to the restriction that none of the implementing actions may restrict the indemnification rights approved by the corporation's stockholders.

Charter and bylaw provisions are most commonly used to convert a corporation's authority to indemnify--which is generally permissive under state corporate law--into an obligation by requiring (rather than simply permitting) indemnification of specified corporate officials.¹⁶² A typical provision states that a corporation "shall" indemnify its officials "to the fullest extent permitted by applicable law." Although very common, such a provision can create uncertainty in states, like Delaware, that have nonexclusivity statutes because there may be no way of determining what the "full extent of the law" permits. In addition, the courts may construe this language as affording rights to indemnification in instances where a corporation did not intend, and may not have wished, to provide it as a matter of right.

A 2002 decision by the Supreme Court of Delaware illustrates the ambiguity inherent in the "fullest extent" language and the possibility that such language may be construed judicially to confer rights that a corporation may not have intended to grant. The courts have generally been split on whether fees incurred to enforce rights to indemnification and advancement--so-called "fees on fees"--are recoverable if not explicitly authorized in a corporation's charter or bylaws or an indemnification agreement. As a means of affording directors and officers additional protection, it is not uncommon for corporations to include in their charters, bylaws or indemnification agreements language expressly

authorizing reimbursement of the costs incurred by a claimant who institutes litigation to enforce rights to indemnification or advances following the denial of a request for payment. In *Stifel Financial Corporation v. Cochran*, the Supreme Court of Delaware held that a bylaw providing mandatory indemnification "to the full extent authorized by law" included fees incurred in pursuing a claim for indemnification.ⁿ¹⁶³ The decision reversed an earlier line of cases establishing that fees on fees are not available unless expressly provided for.ⁿ¹⁶⁴

Although *Stifel* did not establish that fees on fees are available in suits to enforce rights to advancement, the Delaware Court of Chancery subsequently has taken the position that under the holding in *Stifel*, corporate officials are entitled to an award of fees incurred in connection with successfully bringing claims for advancement.ⁿ¹⁶⁵ The Court of Chancery has further concluded that, under *Stifel*, if a corporation does not want to incur the obligation to pay fees on fees, it must expressly preclude any such right.ⁿ¹⁶⁶

In *Weaver v. ZeniMax Media, Inc.*, the Delaware Court of Chancery held that, under *Stifel*, " 'fees on fees' are an inherent right of the party materially successful in asserting a claim for indemnification or advancement unless the corporation, as it may, chooses to deny that right."ⁿ¹⁶⁷ The court concluded that the *Stifel* holding was not dependent upon the "full extent" language in an indemnification bylaw, but rather, among other things, upon the conclusion that indemnification rights would be incomplete without the ability to obtain litigation costs incurred to vindicate these rights.ⁿ¹⁶⁸ Additionally, in May of 2007, the Delaware Court of Chancery ruled that the provisions in indemnification agreements that mandate fees on fees in *unsuccessful* suits to enforce indemnification and advancement rights were unenforceable in connection with a claim brought by a company's former nonmanagement directors to obtain indemnification for monies paid in settlement on their behalf by a third party.ⁿ¹⁶⁹ The agreements in question provided for payment of fees on fees "regardless of whether [an indemnitee] is ultimately determined to be entitled" to indemnification or advances. Noting that the Delaware courts had not previously addressed whether a company could provide such an expansive right to fees on fees, the court concluded that the fees on fees provision was invalid after considering relevant precedent and the framework of Section 145 of the Delaware General Corporation Law. According to the court, a party's right to fees on fees hinges upon its success in the underlying action and partial success in an action leads to partial indemnification of the party's fees commensurate with the extent of the victory.ⁿ¹⁷⁰ Discussing the public policy rationale for its conclusion, the court stated that allowing fees on fees in connection with unsuccessful claims would "encourage directors and officers to bring non-meritorious claims against the corporation."ⁿ¹⁷¹ In view of these decisions, and for purposes of certainty, it is preferable for Delaware corporations to address the issue of fees on fees explicitly in the case of both indemnification and advancements.

As the discussion of fees on fees illustrates, bylaw and charter provisions can also be used to provide greater clarity and specificity with respect to indemnification rights. Many indemnification statutes, including Delaware's, grant authority to indemnify employees and agents, as well as officers and directors. A typical bylaw provision would grant mandatory indemnification to officers and directors and permissive indemnification to employees and agents, although some companies do provide mandatory indemnification rights to all employees and an even smaller number of companies provide mandatory indemnification rights to agents. It may, however, be appropriate to limit mandatory indemnification rights to directors and officers, since a corporation may not want to commit in advance to indemnify all employees and agents without the opportunity to consider or negotiate the terms of indemnification. Corporations--particularly larger ones--may wish to preserve this opportunity in the case of lower-level employees and agents through permissive indemnification rather than granting them an automatic right to indemnification.

Two 2008 Delaware cases illustrate the unintended consequences that may arise where companies provide agents with mandatory indemnification and advancement rights. In *Jackson Walker L.L.P. v. Spira Footwear, Inc.*, the Delaware Court of Chancery held that Spira Footwear, Inc.'s former outside litigation counsel was an "agent" under the company's indemnification bylaw.ⁿ¹⁷² The court defined the term "agent" in the indemnification context to include individuals and organizations, such as a law firm, that act on behalf of a company in relations with third parties. The court distinguished between different types of legal services that can result in agent status for indemnification purposes, stating that the concept of "agent" would not include a lawyer who acts as a legal advisor to a corporate client but does

not act on the client's behalf with respect to third parties. Conversely, the Court of Chancery concluded that attorneys representing a client in litigation would be considered agents because they have the ability to bind their clients in dealings with the court and other parties to the litigation. Based on this definition, the court held that Spira Footwear had to advance expenses to its former outside litigation counsel under a bylaw provision that mandated advancement of expenses to directors, officers, employees and agents. In reaching its decision, the court observed that "Delaware courts understandably proceed with caution in granting advancement and indemnification to agents in general, and to attorneys in particular,"¹⁷³ but that Delaware law gives companies the option of indemnifying and advancing litigation expenses for their agents.

Similarly, in *Zaman v. Amedeo Holdings, Inc.*, the Delaware Court of Chancery held that two attorneys with broad managerial and financial authority over numerous entities controlled by Prince Jefri of the Brunei Royal Family were "agents" of these entities and were therefore entitled to indemnification and advancement with respect to expenses incurred in defending claims brought against them by those same entities.¹⁷⁴ The bylaws of the relevant entities provided for mandatory indemnification and advancement to persons serving at the request of the entities as agents of other entities.¹⁷⁵

Indemnification bylaws and charter provisions also frequently provide that a corporation will indemnify employees who serve as trustees or other fiduciaries of employee benefit plans, as well as directors, officers and employees who serve at the request of the corporation in analogous capacities at a subsidiary of the corporation or an entity in which the corporation has an interest.

Bylaw provisions may also address in greater detail than is provided by statute the rights of successors to corporate officials originally covered by an indemnification bylaw, as well as the rights to continuing indemnification after termination of an individual's relationship with the corporation.¹⁷⁶ A typical bylaw would provide that heirs, personal representatives, and estates of indemnitees may obtain indemnification to the same extent as a deceased indemnitee for claims arising out of the indemnitee's service to the corporation. A typical provision on continuing indemnification would provide that an individual's rights to indemnification survive termination of service to the corporation with respect to claims relating to the period during which the individual served at the corporation.

Importantly, charter and bylaw provisions can also provide additional clarity about the types of proceedings with respect to which indemnification is available. Absent express language, it is not always certain, for example, whether indemnification and advances are available in investigative proceedings, or whether and to what degree expenses of settlement are indemnifiable. For example, preliminary investigations by law enforcement or administrative agencies, internal corporate investigations, and Congressional investigations and hearings may not result in the institution of a formal proceeding, although it may be appropriate to advance funds to directors, officers and others who must respond to such investigations. Similarly, in some states, there may be questions about the availability of indemnification of and advances for settlement amounts in derivative suits.¹⁷⁷ Even in jurisdictions that do permit indemnification of such amounts,¹⁷⁸ a bylaw or charter provision that does not explicitly address the treatment of settlements may be construed judicially as not covering them. A common form of charter or bylaw provision would permit, or mandate, indemnification of settlement amounts and related expenses.

Charter and bylaw provisions also frequently incorporate burden-shifting mechanisms and other procedural provisions that may afford an additional layer of protection to directors and officers when they make a demand for indemnification or advancement. While Section 145(d) of the Delaware indemnification statute provides that the grant of discretionary indemnification must be determined "in the specific case," it does not specify who has the burden of proof of entitlement. Thus, a typical burden-shifting provision places the burden on the corporation's board of directors or other authorized party to make an affirmative finding that an individual seeking indemnification has not met the statutory standard of conduct and is not entitled to indemnification. This relieves the individual of having to carry the initial burden of proving that he or she is entitled to indemnification by virtue of having met the requisite standard. Such a mechanism is often accompanied by language indicating that indemnification is mandatory, or that the indemnitee is

presumed entitled to indemnification, if the board or other authorized party fails or refuses to act within a specified period of time following receipt of a request for indemnification. Although, as noted above, these types of provisions may afford directors and officers additional protection, they have not been tested in court. Accordingly, it is unclear how courts would view them under Section 145(d) of the Delaware General Corporation Law, which includes a procedure for authorizing indemnification,¹⁷⁹ and Delaware's nonexclusivity provision.¹⁸⁰

Similar language is often seen with respect to advances. Some corporations, for example, have provided in the certificate of incorporation or bylaws that the entitlement to advances is mandatory and automatic unless the corporation takes affirmative steps to deny a claim and subject, in the case of current officers and directors, to receipt of the required undertaking to repay any amounts advanced in the event it is determined that the officer or director did not meet the statutory standard of conduct.¹⁸¹ For reasons discussed earlier in this Subsection 5.03[8], in certain instances it may be advisable to leave determinations about advances to the discretion of the board or other appropriate decision-making authority. To provide additional protection to corporate officials, some corporations include language establishing that a denial by the corporation of a request for indemnification or advances is not a defense in a suit by an official to enforce rights to indemnification.

Another element of a charter or bylaw provision that is essential in view of the uncertainty surrounding many areas of the law relating to indemnification is a "savings" or "severability" clause. The purpose of such a clause is to preserve the remainder of an indemnification provision to the extent that any portion of the provision is found to be unenforceable.

[9] Indemnification Agreements

Indemnification agreements with directors, officers and other corporate officials are used to accomplish many of the same purposes as charter and bylaw provisions. In states (such as Delaware) that have nonexclusivity provisions, indemnification agreements may provide for a variety of rights that are not explicitly spelled out in the indemnification statute and that are, at the same time, consistent with the statute. These rights may include:

- (1) mandatory indemnification, unless prohibited by statute;
- (2) mandatory advancement of expenses, which the indemnitee can, in many instances, obtain on demand, subject to the provision of an undertaking to repay, if required;
- (3) accelerated procedures for "determination" of entitlements to indemnification;
- (4) litigation "appeal" rights in the event of an unfavorable determination by the corporation;
- (5) procedures under which a favorable determination will be deemed to have been made under circumstances where the board or other appropriate body fails or refuses to act;
- (6) reasonable funding mechanisms; and
- (7) rights to "fees on fees."¹⁸²

While it is also possible to provide for rights that go above and beyond those explicitly granted by statute through the use of charter or bylaw provisions, these rights may be more secure to the extent they are guaranteed by contract. It is unclear, however, whether a contractual right to indemnification would be enforceable if a corporate official were not entitled to indemnification under state law.¹⁸³ As with rights granted under charter and bylaw provisions, rights articulated in indemnification agreements likely will be subject to public policy and other substantive limitations embodied in a state's indemnification statute.¹⁸⁴ Accordingly, although the enforceability of indemnification agreements has been upheld as a general matter,¹⁸⁵ it is unclear how specific contractual provisions that may be

argued to contravene public policy--such as those permitting indemnification of settlement and judgment amounts in derivative suits--would be viewed by a court if challenged.

There are, however, several advantages to providing for indemnification rights in a separate agreement instead of, or in addition to, any rights established in the corporation's certificate of incorporation or bylaws:

- As an initial matter, indemnification agreements may be more readily enforceable by corporate officials because they reflect bargained-for consideration in the form of an individual's agreement to accept or continue service with the corporation.
- An indemnification agreement also affords more protection than charter or bylaw provisions because it is not subject to unilateral amendment or rescission by the corporation and, thus, would not be jeopardized by a change in control or the termination of an individual's service with a corporation.¹⁸⁶
- A contract also allows a corporation to tailor protections to the specific circumstances of the individuals involved and to provide protections commensurate with the nature and level of their responsibilities and their potential for exposure. It would, for example, be customary to provide directors and executive officers with greater rights than lower-level management because of the increased exposure to liability that accompanies their significant responsibilities.
- In addition, it is possible to afford individuals that perform specialized functions, such as serving as a trustee of an employee benefit plan or a director of a subsidiary or affiliated entity, with the protection of an express contractual provision that extends indemnification and related rights to their service in those specialized capacities.
- Finally, the existence of a separate agreement that is personal to an individual director or officer can provide a degree of psychological security that may not be present with a bylaw or charter provision of more general application.

Many of the same principles that apply when drafting a charter or bylaw provision also apply to the drafting of indemnification agreements. For example, where a corporation intends to provide for mandatory advancement of expenses or "fees on fees," this intention should be stated clearly in the indemnification agreement. A provision mandating indemnification, without making reference to advances, may be construed by a court not to cover advances.¹⁸⁷ Conversely, if a corporation intends to limit the right to advancement in certain circumstances, such as where the board determines, at some point during the course of a legal proceeding, that an individual has acted improperly, the agreement should articulate this clearly.¹⁸⁸

Similarly, to avoid ambiguity, the agreement should state expressly that an undertaking is required and whether or not it need be secured. It may also be appropriate to address whether, and to what extent, indemnification and advances are available outside the scope of an "action, suit or proceeding"--for example in investigative proceedings or proceedings where a director or officer is not a party but serves as a witness. By addressing these types of eventualities, the indemnification agreement can be tailored to define and limit the corporation's exposure, while at the same time providing clarity and additional protection for officers and directors. In view of the uncertainties about the types of claims that may be indemnified, a severability clause is also important to insulate and preserve the remainder of the indemnification agreement in the event that one or more provisions is deemed to be invalid.

Appendix 5-C to this chapter contains a sample indemnification agreement for a Delaware company. This particular sample agreement was drafted with a view to providing the broadest possible rights to directors and officers.

[10] Alternative Funding Mechanisms

The availability of indemnification, whether under charter or bylaw provisions or separate indemnification agreements, is ultimately dependent on a corporation's ability to pay. This ability may be compromised where a corporation is experiencing financial difficulties or if the corporation is insolvent, in which case the corporation's assets may be subject to the claims of other creditors.ⁿ¹⁸⁹ The availability of indemnification may also be jeopardized following a change in control of a corporation if a new board of directors is unwilling to authorize indemnification payments to outgoing officers and directors. Coverage under a D&O insurance policy may not be available or may be subject to limitations and exclusions, depending on the circumstances. In recognition of these possibilities, and in an effort to provide their directors and officers with the maximum possible protection from personal liability, many corporations are increasingly exploring alternative ways to fund indemnification, as well as alternatives to traditional D&O insurance.ⁿ¹⁹⁰

Alternative funding mechanisms generally fall into two categories:

- (1) mechanisms such as indemnification trusts and letters of credit that serve as a means of funding indemnification by segregating funds and authorizing their release when certain procedures are followed; and
- (2) mechanisms such as captive insurance company policies, finite risk policies, and fronting arrangements that may serve as a substitute for traditional D&O insurance and that, like such insurance, can provide coverage for claims that may not be indemnifiable under state and federal law.

Whether mechanisms such as captive insurance company policies can function as a substitute for traditional insurance depends on whether they constitute "insurance" under state and federal law. This, in turn, is significant because if an alternative funding arrangement does not constitute insurance, amounts used to fund the arrangement--the equivalent of traditional insurance premiums--may not be deductible for tax purposes. In addition, payment of these "premiums" may not be authorized with corporate funds under a state statute that, like Delaware's,ⁿ¹⁹¹ permits the purchase of insurance but does not explicitly authorize expenditures for special arrangements. Finally, if an alternative funding mechanism is not classified as insurance, it may be subject to the same public policy limitations as indemnification. Accordingly, the mechanism would not provide protection for claims that are not indemnifiable under state and federal law.ⁿ¹⁹²

Some states have amended their indemnification statutes to provide express authorization for alternative funding mechanisms.ⁿ¹⁹³ Although, as noted above, Delaware is not among them, the Delaware statute does authorize the purchase of insurance.ⁿ¹⁹⁴ In addition, some statutes provide that, in the absence of actual fraud, a board decision concerning the terms and conditions of insurance or alternative funding arrangements is "conclusive," and that the insurance or alternative funding arrangement is not voidable and no director can be subjected to liability for a decision approving its terms and conditions, even where the director is a beneficiary of the arrangement.ⁿ¹⁹⁵ Such provisions may afford directors protection in the event that the establishment of alternative funding mechanisms are otherwise subject to attack under state law principles relating to breach of directors' duties. Because the corporate officials who establish such mechanisms will also be its beneficiaries, their decisions may be subject to heightened scrutiny.

One common vehicle for funding indemnification is an indemnification trust.ⁿ¹⁹⁶ Indemnification trusts are appealing as alternative funding mechanisms because, if appropriately structured, they can provide directors, officers and other covered persons with greater comfort that funding will be available in the event of insolvency or a change in control. Under an indemnification trust, a third party trustee, typically a bank or one or more individuals, holds in trust funds that a corporation deposits for the benefit of corporate officials entitled to indemnification. Claims for indemnification are paid as they arise in accordance with procedures set forth in the trust documents. The governing documents may provide for the corporation to administer indemnification claims directly by determining the availability of indemnification and then directing payments by the trustee. Alternatively, the trustee may be given the authority to receive claims and make determinations about the entitlement to indemnification.

Although indemnification trusts have received only limited judicial scrutiny, relevant case law suggests that they are enforceable as a general matter. The leading case upholding indemnification trusts, *Security America Corp. v. Walsh*, upheld the validity under Delaware law of two irrevocable and unamendable trusts established in the face of a change in control to provide for the advancement of expenses to outgoing directors.ⁿ¹⁹⁷ Although the court noted the "troubling circumstances" surrounding the establishment of the trusts,ⁿ¹⁹⁸ it emphasized the underlying right to indemnification established in the corporation's bylaws in holding that the use of the indemnification trusts was proper:

[The corporation's new board] contends that the trusts disable the corporation from reviewing a discretionary decision on a continuing basis and that there is no guarantee that the defendants can ever repay. True it is that the trust put beyond the reach of the present management the decision not to advance expenses, a decision which is normally reviewable. Nor is there a certainty of repayments. It is clear, however, that the bylaws, adopted long before this dispute arose, contemplated such advances and the directors accepted their positions with that knowledge; that the present management had the pronounced intention not to exercise discretion but to terminate litigation support; and that the likelihood that [the corporation] would in the future be able to respond to a legal obligation to indemnify was far more questionable than the likelihood that defendants, collectively, could repay. Given the policy of the Delaware law, this court is persuaded that the trusts, in the circumstances presented here, were permissible.ⁿ¹⁹⁹

Like the trusts in *Security America*, an appropriately structured indemnification trust should be irrevocable and unamendable.ⁿ²⁰⁰ This assures, to the extent possible, that the corpus of the trust will be beyond the reach of creditors in the event of insolvency and that new management will not have the ability to amend the terms of trust--and possibly deny indemnification--following a change in control. Although trust documents could provide that a trust becomes irrevocable and unamendable automatically upon a change of control or insolvency, this may make the trust more vulnerable to challenge by a bankruptcy trustee.ⁿ²⁰¹

The indemnification trust at issue in *Askanase v. LivingWell, Inc.* provided that "[c]hanges to this Trust Agreement may be made at any time or from time to time by the Company by resolution of its Board of Directors, and provided that in no case shall an amendment affect the rights, duties or responsibilities of the Trustee or Administrator without its consent."ⁿ²⁰² The court interpreted this language as granting the board of directors "a nearly unlimited power of amendment" and upheld the authority of the bankruptcy trustee (as successor to the board) to terminate the trust.ⁿ²⁰³ After terminating the trust, the trustee filed a lawsuit against the corporation's former officers and directors asserting claims that the trust had been designed to cover and arguing that the officers and directors were not entitled to have indemnification and expenses relating to the suit paid from the trust because they had filed claims subsequent to its termination.ⁿ²⁰⁴ Although the Court of Appeals instructed the lower court to consider on remand whether there were any valid claims against the trust corpus, it noted that, because any funds remaining after valid claims were paid would be returned to the bankruptcy estate, "claims for indemnification of the former directors and officers not covered by the trust as terminated ... can be pursued as claims against the estate."ⁿ²⁰⁵

It is important to note that the use of an indemnification trust does not extend the scope of the substantive coverage available under applicable law and any relevant charter or bylaw provisions and indemnification agreements. In this regard, indemnification trusts are generally thought to be subject to applicable statutory and public policy limitations on indemnification.

Unlike D&O insurance, and some of the alternatives to D&O insurance,ⁿ²⁰⁶ an indemnification trust does not involve the shifting of risk away from the corporation to a third party. Accordingly, one of the primary benefits of insurance--the availability of coverage for claims that are not indemnifiable under state law--is generally not available through indemnification trusts.ⁿ²⁰⁷ The indemnification statutes of some states, however, do permit indemnification trusts to cover liabilities that corporations cannot indemnify, including statutes in Louisiana, Maryland, Nevada, New

Mexico, Ohio, Pennsylvania and Texas.ⁿ²⁰⁸

As is the case with indemnification, the practical value of indemnification trusts is dependent on a corporation's financial resources and, specifically, its ability to fund the trust corpus. For this reason, a corporation considering the establishment of an indemnification trust should take steps to put the trust arrangement in place at a time when the corporation is financially healthy and before any substantial claims for indemnification have been made. This is crucial not only because the corporation must have sufficient assets to fund the trust, but also because an indemnification trust may also be subject to attack under state fraudulent conveyance laws and federal bankruptcy laws. A successful challenge under these laws could result in the trust being deemed void and the transfer of assets to the trust being set aside. The closer in time to its insolvency that a corporation establishes an indemnification trust, the greater the likelihood that it may be set aside. By contrast, an irrevocable indemnification trust that is funded at a reasonable level at time when a corporation is solvent should be able to withstand attack by a corporation's creditors or a trustee in bankruptcy.

Another alternative funding mechanism that companies often consider is a captive insurance company policy.ⁿ²⁰⁹ Obtaining coverage under such a policy requires the formation and capitalization of a wholly-owned insurance company by a parent entity, such as a public company. The captive insurance company is managed by insurance brokers or other professional insurance managers and it provides insurance policies to its parent that are generally modeled on commercially available policies, except that it may omit exclusions and restrictions that are objectionable to the parent company. A captive insurance company can provide cost-reduction benefits because its premium schedules focus on the parent's loss history and actuarial analysis.

Whether a captive insurance company policy can fill key gaps in indemnification coverage depends on whether it constitutes "insurance" under state and federal law. Because insurance generally involves a spreading or shifting of risk of loss,ⁿ²¹⁰ an insurance policy that assigns the risk of loss to a wholly-owned captive company--whose profits and losses are borne entirely by the parent company--is unlikely to qualify as insurance. Among other things, this would mean that a pure captive insurance company policy could be subject to the same public policy limitations that apply to indemnification. Although a "group captive insurance company," in which risk is spread among a number of unrelated corporations, would address the issue of risk-sharing, establishing a group captive insurance company may be difficult because each participant must agree on the terms of implementation, and each must be comfortable with the others' risks.

Another alternative funding mechanism is a finite risk policy. Properly structured finite risk policies combine the transfer of risk with a profit-sharing arrangement between the insurance company and its client, who share in the risks and returns based on the losses paid out under the policy and the income earned on premiums. Under a finite risk policy, a public company would obtain a defined amount of coverage in exchange for paying a sizeable premium--one that is large enough to fund a portion of the losses anticipated under the policy--and that earns investment income over the life of the policy. In the event of a favorable loss experience (*i.e.*, where the losses under policy are less than the premium paid by the company), the company can recover a portion of the premium plus associated investment income.

Finite risk policies raise complex tax and accounting issues. As with the other alternative funding mechanisms discussed above (except indemnification trusts), whether finite risk policies can afford protection beyond that provided by indemnification and traditional insurance depends on whether these policies constitute "insurance," which, in turn, depends on how much risk is transferred under the policy. For a number of years, many accountants and insurance practitioners applied what is known as the "10/10 rule" for purposes of determining whether a finite risk policy could be considered "reinsurance" for accounting purposes--, meaning that there had to be at least a 10% probability of a 10% economic loss to the reinsurer on the finite risk policy.ⁿ²¹¹ However, in the last few years, this rule has fallen out of use in favor of a more conservative approach as finite risk insurance has come under increased scrutiny,ⁿ²¹² with regulators launching investigations into the use of finite risk insurance and other reinsurance products, looking specifically at whether some insurers had been using finite risk insurance arrangements that involve little or no transfer

of risk to "smooth" their earnings or otherwise distort their financial statements. In particular, finite risk policies have been the subject of litigation and regulatory proceedings in connection with a series of transactions between General Re Corporation and American International Group, Inc. In March 2008, following a multi-week trial, several defendants in the criminal cases were found guilty of having engaged in fraudulent finite risk transactions. The trial focused in part on the issue of loss reserves associated with the finite risk policies in question. Following the trial, Gen Re's CEO, Joseph Brandon, resigned and by April 2009 each of the defendants had been sentenced to prison terms ranging from one to four years, although the defendants continue to appeal their sentences. In the wake of this and other controversies involving the use of finite risk insurance, companies are advised to proceed with care in evaluating whether finite risk policies can provide an alternative to traditional insurance.

Fronting arrangements, which are similar to finite risk policies, permit a corporation to share in a positive loss experience through premium recapture, but also require the corporation to reimburse the insurer in full for any losses paid out in excess of premiums received. It is unclear whether a fronting arrangement involves any real risk transfer to the insurer, and thus, whether it qualifies as "insurance."

[11] Indemnification in the Private Equity Context

In 2007 and 2008, there were a series of decisions in the Delaware Court of Chancery that are relevant to indemnification and advancement of expenses in the private equity context. The first of these decisions, *Levy v. HLI Operating Co., Inc.*, addressed the relative indemnification obligations of a private equity fund and one of its portfolio companies.²¹³ Private equity funds routinely appoint fund representatives to serve on the boards of directors of their portfolio companies. These individuals are typically entitled to indemnification and advancements of expenses under the funds' organizational documents, as well as the charter and/or bylaws of the portfolio companies and, in some cases, separate indemnification agreements if the portfolio company has them. Prior to the court's decision in *Levy*, many expected that a portfolio company would be primarily responsible for paying indemnification and advancement obligations if a fund representative were sued in his or her capacity as a director of the portfolio company. *Levy*, however, changed this expectation.

In *Levy*, a private equity fund appointed four of its principals to serve on the board of a portfolio company. When the portfolio company announced that some of its financial statements were inaccurate, stockholders and bondholders sued the company and certain officers and directors, including the fund's representatives. In connection with settling the lawsuit, the private equity fund paid a portion of the total settlement amount on the representatives' behalf, pursuant to its obligation to indemnify the representatives under the fund's limited partnership agreement. The representatives sought to recover the amounts paid by the private equity fund from the portfolio company pursuant to indemnification agreements between the portfolio company and the representatives. The Delaware Court of Chancery held that the fund representatives could not seek indemnification for the settlement amounts from the portfolio company because the private equity fund had already paid on their behalf. The court also held that the private equity fund could seek contribution directly from its portfolio company because the fund and its portfolio company owed concurrent indemnification obligations and each was therefore responsible for half of the amounts paid in respect of these obligations. The reason the court found that the indemnification obligations of the two entities were concurrent was because both the fund and the portfolio company were contractually obligated to indemnify the director-appointees.

In *Schoon v. Troy*, the Delaware Court of Chancery reached a different result based on the fact that a company's significant stockholder had voluntarily undertaken to advance litigation expenses to the directors it had appointed to the company's board.²¹⁴ The court determined that the directors could still pursue indemnification and advancement claims against the company, because unlike in *Levy*, the significant stockholder had not undertaken an obligation to indemnify or advance expenses to the directors, so the company's indemnification and advancement obligations had not been extinguished.

A third case, *Sodano v. American Stock Exchange*, confirmed that parties can contract around the result in *Levy* by

prioritizing indemnification and advancement obligations.ⁿ²¹⁵ In *Sodano*, the indemnification dispute was between the American Stock Exchange, or Amex, and the NASD, which owned Amex at the time. The Delaware Court of Chancery upheld a priority provision in the NASD's organizational documents that rendered its indemnification and advancement obligations secondary to the obligations of Amex.

Accordingly, a private equity fund can avoid the result in *Levy* by reviewing its own indemnification and advancement obligations and those of its portfolio companies early on, so that it and its portfolio companies know the extent of their respective obligations and documents can be drafted accordingly to reflect the intentions of the parties with respect to the priority of these obligations. One solution to the issue raised in the *Levy* case is a "priority agreement" between the private equity fund and the portfolio company. This type of agreement would make clear that the portfolio company is primarily liable for indemnification and advancement of expenses to private equity fund representatives serving on the portfolio company board. The agreement would specify that the portfolio company agrees to indemnify and advance expenses to the fund representatives in accordance with the terms of the company's organizational documents and any indemnification contracts. The agreement also would make clear that, if the private equity fund steps in and actually pays indemnification or advancement to the fund representatives, then the fund is entitled to reimbursement for those amounts from the portfolio company. Similar types of "priority" provisions also can be included in the private equity fund's organizational documents.ⁿ²¹⁶ These provisions would require that individuals look first to the portfolio company for indemnification and advancement and would state that the fund is liable for indemnification and advancement only if, and to the extent that, the portfolio company does not pay. The private equity fund also could require individuals to reimburse it for any amounts paid by the fund to the extent they receive payment from the portfolio company.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral
OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesIndemnification

FOOTNOTES:

(n1)Footnote 1. See John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 4:4 (Thomson West 2003 & Supp. 2008-09 (revision by Jennifer Berger & Mitchell A. Kaufman)).

(n2)Footnote 2. See John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 5:2 (Thomson West 2003 & Supp. 2008-09 (revision by Jennifer Berger & Mitchell A. Kaufman)) (in accordance with a conflict-of-laws rule known as the "internal affairs doctrine," issues relating to the internal affairs of a corporation, such as indemnification, are decided in accordance with the law of the state of incorporation).

(n3)Footnote 3. See Mark A. Sargent & Dennis R. Honabach, *D&O Liability Handbook: Law-Sample Documents-Forms* (Thomson West 2009) (compiling and discussing indemnification statutes of various jurisdictions).

(n4)Footnote 4. See *Del. Code Ann. tit. 8, § 145* (2009).

(n5)Footnote 5. Delaware's original indemnification statute served as the model for the indemnification provision in the Model Business Corporation Act of 1950, the first version of the Model Act. In 1967, when Delaware's new General Corporation Law was published, it included a comprehensive redraft of the indemnification provisions. Over the next 15 years, 27 states adopted some form of the Delaware indemnification statute. See John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 4:24 (Thomson West 2003 (revision by Jennifer Berger & Mitchell A. Kaufman)). Today, seven states have adopted Section 145 of the Delaware General Corporation Law almost verbatim. See Model Bus. Corp. Act Ann. § 8.50 statutory comparison (4th ed. 2008) (stating that Arkansas,

Illinois, Kansas, Missouri, Oklahoma and Pennsylvania have adopted statutes that closely track Section 145 of the Delaware General Corporation Law).

(n6)Footnote 6. *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998) (citation omitted).

(n7)Footnote 7. *Del. Code Ann. tit. 8, § 145* (2009). As is true for directors, under certain circumstances, indemnification of officers is mandatory. *See Del. Code Ann. tit. 8, § 145(c)* (2009).

(n8)Footnote 8. *Del. Code Ann. tit. 8, §§ 145(a) & (b)* (2009).

(n9)Footnote 9. *See Del. Code Ann. tit. 8, §§ 145(a) & (b)* (2009).

(n10)Footnote 10. *Del. Code Ann. tit. 8, § 145(j)* (2000). Under Section 145(j) of the Delaware General Corporation Law, a corporation must act at the time a grant of indemnification is authorized or ratified in order to limit rights to continuing indemnification.

(n11)Footnote 11. *See Del. Code Ann. tit. 8, § 145(f)* (effective Aug. 1, 2009); *see also* Synopsis, House Bill No. 19 (Apr. 10, 2009), available at <http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19?Opendocument>. The restriction on retroactive amendments also applies to the advancement of expenses and was a legislative response to the result in *Schoon v. Troy*, 948 A.2d 1157 (Del. Ch. 2008), discussed in § 5.03[5] below.

(n12)Footnote 12. *Del. Code Ann. tit. 8, § 145(h)* (2000).

(n13)Footnote 13. *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 214 (Del. 2005).

(n14)Footnote 14. *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 83-85 (Del. 1998). *See also, e.g., Heffernan v. Pacific Dunlop GNB Corp.*, 965 F.2d 369, 373, 375 (7th Cir. 1992) (applying Delaware law and stating that "Delaware's "by reason of the fact that" phrase is "broad enough to encompass suits against a director in his official capacity as well as suits against a director that arise more tangentially from his role, position or status as a director. ... In employing its 'by reason of' phrase, Delaware is able to cover a myriad of potential factual scenarios that cannot be anticipated *ex ante* by the legislature or by corporate officials in drafting their articles and bylaws."); *Mooney v. Willys-Overland Motors, Inc.*, 204 F.2d 888, 896-97 (3d Cir. 1953) (individual entitled to indemnification for expenses where complaint charged him with wrongful actions not only as controlling stockholder but also as officer and director).

(n15)Footnote 15. *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 213 & 214 (Del. 2005).

(n16)Footnote 16. *Homestore*, 888 A.2d at 213-14.

(n17)Footnote 17. *Homestore*, 888 A.2d at 214 (citations omitted); *see also id.* (noting "consistent line of authority upholding the contractual and statutory advancement and indemnification rights of corporate officials charged with serious misconduct allegedly inspired by personal greed") (citations omitted).

(n18)Footnote 18. *See In Re Adelpia Communs. Corp.*, 323 B.R. 345 (Bankr. S.D.N.Y. 2005).

(n19)Footnote 19. *In re Adelpia*, 323 B.R. at 378-79.

(n20)Footnote 20. *In re Adelpia*, 323 B.R. at 378.

(n21)Footnote 21. *In re Adelpia*, 323 B.R. at 379 n.112.

(n22)Footnote 22. *See, e.g., Kaufman v. CBS, Inc.*, 514 N.Y.S.2d 620, 1987 N.Y. Misc. LEXIS 2178 (N.Y. Civ. Ct. 1987) (corporate officer was not entitled to indemnification for the costs of defending a sexual harassment lawsuit because actions were viewed as outside the scope of the officer's employment).

(n23)Footnote 23. *Del. Code Ann. tit. 8, § 145(c)* (2009). The Delaware statute was amended in 1997 to eliminate mandatory statutory indemnification of expenses for non-director and non-officer employees and agents, effective for all acts and omissions occurring after July 1, 1997. *See Del. Code Ann. tit. 8, amended by 71 Del. Laws 120 (1997).*

(n24)Footnote 24. *See, e.g., Green v. Westcap Corp. of Delaware, 492 A.2d 260 (Del. Super. Ct. 1985).*

(n25)Footnote 25. *See, e.g., Cochran v. Stifel Fin. Corp., 2000 Del. Ch. LEXIS 179, at *4 n.10 (Dec. 13, 2000), aff'd in part, rev'd in part on other grounds, 809 A.2d 555 (Del. 2002)* (awarding defendant indemnification for claims he successfully defended and noting parties' position that, where separate claims brought in one action can be sensibly segregated for purposes of analyzing whether indemnity is owed, the court may segregate the claims) (citing *Meritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 141 (Del. Super. Ct. 1974)*).

(n26)Footnote 26. *See, e.g., Owens-Corning v. National Union Fire Ins. Co., 257 F.3d 484, 496 (6th Cir. 2001); Waltuch v. Conticommodity Servs., Inc., 88 F.3d 87, 95-97 (2d Cir. 1997); Safeway Stores, Inc. v. National Union Fire Ins. Co., 64 F.3d 1282, 1290 n.24 (9th Cir. 1995); Wisener v. Air Express Int'l Corp., 583 F.2d 579, 583 (2d Cir. 1978); VonFeldt v. Stifel Fin. Corp., CA 15688, 1999 Del. Ch. LEXIS 131, at *15-*16 (June 11, 1999); B&B Inv. Club v. Kleinert's, Inc., 472 F. Supp. 787, 790-791 (E.D. Pa. 1979).* Each of these cases involved settlements that did not require the individual seeking indemnification to pay any monetary damages or concede liability. In *Owens-Corning*, the Sixth Circuit, interpreting Delaware law, held that defendants who had paid a settlement of almost \$10 million could not rely on Section 145(c) as a basis for obtaining indemnification. *See Owens-Corning, 257 F.3d at 495.* Finding it "extremely dubious" that Delaware courts would view a \$10 million settlement as a "success" for purposes of Section 145(c), the court pointed to the explicit references to settlement amounts in Sections 145(a) and 145(b) as a "strong indication" that Section 145(c) was not intended "to be ordinarily applicable to settlements." *Owens-Corning, 257 F.3d at 495.* The court did indicate, however, that if the amount of a settlement were lower than the expected attorneys' fees and costs that would be incurred in the absence of the settlement, there was a "good argument" for success under Section 145(c) despite payment. *Owens-Corning, 257 F.3d at 495 n.6.* In making this statement, the Sixth Circuit cited a Delaware Chancery Court decision in which the court acknowledged that "room might exist for recognizing that dismissal with prejudice with the payment of nominal consideration, amounting perhaps to the nuisance value of the suit, is an appropriate understanding of the phrase 'success on the merits or otherwise.'" *VonFeldt, 1999 Del. Ch. LEXIS 131, at *16.* In *VonFeldt*, and in *Waltuch*, the courts declined to reach the issue of whether a settlement payment automatically renders a defendant unsuccessful under Section 145(c) of the Delaware General Corporation Law. *See VonFeldt, 1999 Del. Ch. LEXIS 131, at *16; Waltuch, 88 F.3d at 96 n.12.*

(n27)Footnote 27. *See, e.g., Galdi v. Berg, 359 F. Supp. 698, 700-702 (D. Del. 1973)* (indemnification award would be premature and contrary to the purpose of the statute where case was dismissed without prejudice so that same issue could be litigated in another pending proceeding, but the defendant was not foreclosed from seeking indemnification if he were ultimately successful on the merits or otherwise in having the charges against him dismissed with prejudice in the other pending cases).

(n28)Footnote 28. Model Bus. Corp. Act Ann. § 8.52 & statutory comparison (4th ed. 2008). The *Merritt-Chapman* case (*see above* (citing *Meritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. Ct. 1974)*)) was instrumental in causing the drafters of the Model Business Corporation Act to move away from the Delaware model and require a defendant to be "wholly successful on the merits or otherwise" in order to be entitled to mandatory indemnification. *See also* Model Bus. Corp. Act Ann. § 8.52 official cmt. (4th ed. 2008). In *Meritt-Chapman*, the court held that a defendant who pled *nolo contendere* to a single count of an indictment in return for dismissal of the remaining counts against him was entitled to mandatory indemnification for litigation expenses incurred in defending all of the counts that were dismissed.

(n29)Footnote 29. Model Bus. Corp. Act Ann. § 8.52 official cmt. (4th ed. 2008).

(n30)Footnote 30. *In re Adelpia Communications Corp., 323 B.R. 345, 379-84 (Bankr. S.D.N.Y. 2005).*

(n31)Footnote 31. *In re Adelpia*, 323 B.R. at 382-83 .

(n32)Footnote 32. *In re Adelpia*, 323 B.R. at 383 .

(n33)Footnote 33. *In re Adelpia*, 323 B.R. at 383 .

(n34)Footnote 34. *In re Adelpia*, 323 B.R. at 383 .

(n35)Footnote 35. See Model Bus. Corp. Act Ann. § 8.52 official cmt. (4th ed. 2008) ("A director who is precluded from mandatory indemnification by the [wholly successful] requirement may still be entitled to permissible indemnification ... or court-ordered indemnification.").

(n36)Footnote 36. See, e.g., *Tafeen v. Homestore, Inc.*, 2004 Del. Ch. LEXIS 38, at *44 (Mar. 22, 2004) .

(n37)Footnote 37. *Tafeen*, 2004 Del Ch. LEXIS 38, at *2 & n.1 (criticizing company that was "[c]ontent to adopt indemnification and advancement bylaws with holes large enough to drive a truck through, [and that] (like so many others in this Court of late) suddenly 'finds religion'--insisting on a rigorous interpretation of its loosely written bylaws").

(n38)Footnote 38. *Del. Code Ann. tit. 8, § 145(a)* (2009).

(n39)Footnote 39. *Del. Code Ann. tit. 8, § 145(b)* (2009).

(n40)Footnote 40. *Del. Code Ann. tit. 8, § 145(d)* (2009).

(n41)Footnote 41. *Del. Code Ann. tit. 8, §§ 145(a) & (b)* (2000).

(n42)Footnote 42. *Del. Code Ann. tit. 8, § 145(a)* (2009).

(n43)Footnote 43. See 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.12[C] (3d ed. Supp. 2009).

(n44)Footnote 44. *Del. Code Ann. tit. 8, § 145(d)* (2009).

(n45)Footnote 45. 71 Del. Laws 120 (1997) (synopsis).

(n46)Footnote 46. *Del. Code Ann. tit. 8, § 145(k)* (2009).

(n47)Footnote 47. *Stifel Financial Corp. v. Cochran*, 809 A.2d 555, 559-561 (Del. 2002) .

(n48)Footnote 48. *Del. Code Ann. tit. 8, § 145(a)* (2009).

(n49)Footnote 49. See *Del. Code Ann. tit. 8, § 145(a)* (2009).

(n50)Footnote 50. *Del. Code Ann. tit. 8, § 145(b)* (2009).

(n51)Footnote 51. *Del. Code Ann. tit. 8, § 145(b)* (2009).

(n52)Footnote 52. See 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.12[A] (3d ed. Supp. 2009).

(n53)Footnote 53. But see 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.12[A] (3d ed. Supp. 2009) (raising but rejecting this argument); S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 *Bus. Law.* 75, 79-80 (1967)

(indicating that the Delaware Corporation Law Revision Committee decided that to "permit the corporation to nullify a judgment in its favor against a director simply by refunding the director's payment on it would, in the committee's judgment, subvert the substantive provisions of the corporation law and should not be permitted." With respect to settlement amounts, the Committee thought that to permit indemnification "would have the ultimate effect of discouraging settlements since, in such a situation, derivative plaintiffs could demonstrate no benefit arising to the corporation from their action and, presumably, could not justify being reimbursed for their litigation expenses, including counsel fees.").

(n54)Footnote 54. *See Del. Code Ann. tit. 8, § 145(f)* (2009).

(n55)Footnote 55. *See, e.g., TLC Beatrice Int'l Holdings, Inc. v. CIGNA Ins. Co., 1999 U.S. Dist. LEXIS 605, at *13-*20 (S.D.N.Y. Jan. 27, 1999)* (New York court interpreting Delaware law concluded that omission of judgment and settlement amounts in derivative suits under Section 145(b) was intentional, rejected argument that indemnification was permitted under Section 145(f), and held that Delaware law does not empower corporations to indemnify directors for settlement amounts in derivative suits); *Arnold v. Society for Sav. Bancorp, 678 A.2d 533, 540 & n.18 (Del. 1996)* (noting that Section 145(b) was intentionally drafted to avoid a circular result where a corporation would simply be paying itself for injury caused to it by the very directors being indemnified by the corporation); *but see Heffernan v. Pacific Dunlop GNB Corp., 1993 U.S. Dist. LEXIS 5, at *15 (N.D. Ill. Jan. 5, 1993)* (Illinois court interpreting Delaware law and upholding bylaw provision permitting indemnification for charges, costs, judgments, fines, and amounts paid to settle suits by or on behalf of a corporation because Delaware statutory law "does not mark the exclusive ambit of indemnification rights" and statutory indemnification rights "co-exist with" rights conferred under corporate bylaws).

(n56)Footnote 56. *Del. Code Ann. tit. 8, § 145(b)* (2009).

(n57)Footnote 57. *Homestore, Inc. v. Tafteen, 888 A.2d 204, 211 (Del. 2005)* (citations omitted).

(n58)Footnote 58. *Del. Code Ann. tit. 8, § 145(e)* (2009).

(n59)Footnote 59. *Del. Code Ann. tit. 8, § 145(e)* (2009).

(n60)Footnote 60. *See, e.g., Tafteen v. Homestore, Inc., 2004 Del. Ch. LEXIS 38 (Mar. 22, 2004)*; In *Homestore*, the court rejected Homestore's argument that advancing expenses to an officer would place the corporation in a position of severe financial hardship where the corporation had a broad advancement bylaw that conditioned payment of advances only on the receipt of an unsecured undertaking to repay. According to the court, the existence of financial hardship was not a defense to a request for advancement when Homestore could have adopted a more stringent bylaw that would have lessened the credit risk posed by the possibility of an inability to repay. *See Homestore, 2004 Del. Ch. LEXIS 38, at *41-*45*.

(n61)Footnote 61. *See, e.g., In re Central Banking System, Inc., 1993 WL 183692, at *3 (Del. Ch. May 11, 1993)* (unpublished) (citing *Essential Enterprise Corp. v. Automatic Steel Prods., Inc., 39 Del. Ch. 371, 164 A.2d 437, 441-441 (Del. Ch. 1960)*).

(n62)Footnote 62. *Tafteen v. Homestore, Inc., 2004 Del. Ch. LEXIS 38, at *2 n.1 and *44-*45* (Mar. 22, 2004).

(n63)Footnote 63. *Homestore, 2004 Del. Ch. LEXIS 38, at *44 & n.71*.

(n64)Footnote 64. *Tafteen v. Homestore, Inc., 2004 Del. Ch. LEXIS 156, at *10 (Oct. 27, 2004)* (unpublished) ("People with far less substantial bank accounts than corporate executives are required to post secured bonds every day in this Court and in our general jurisdiction law courts. For a corporate executive being paid hundreds of thousands of dollars or more a year in salary and benefits, this Court is hard pressed to understand why it would be difficult to attract people to such positions if they were required to post a bond to secure the advancement of fees and costs related to

litigation arising from their service in that capacity."). *Homestore, 2004 Del. Ch. LEXIS 156, at *10-*11* .

(n65)Footnote 65. *See, e.g., Tafeen v. Homestore, Inc., 2004 Del. Ch. LEXIS 38, at *2 & n.1* (Mar. 22, 2004) (stating that companies may not "adopt indemnification and advancement bylaws with holes large enough to drive a truck through" and then "suddenly 'find[] religion' [and] insist ... on a rigorous interpretation of ... loosely written bylaws"); *see also* John Mark Zeberkiewicz & Blake Rohrbacher, *No Surprises: The Mandatory Nature of Mandatory Advancement and Indemnification*, 15 *The Corporate Governance Advisor* No. 6 (Nov./Dec. 2007).

(n66)Footnote 66. *Delucca v. KKAT Management, L.L.C., 2006 Del. Ch. LEXIS 19, at *6-*7* (Jan. 30, 2006) (unpublished).

(n67)Footnote 67. *Radiancy, Inc. v. Azar, 2006 Del. Ch. LEXIS 13, at *1-*2* (Jan. 23, 2006) (unpublished).

(n68)Footnote 68. For a discussion of the *Homestore* litigation, *see* Stephen A. Radin, "Sinners Who Find Religion": *Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing*, 25 *Rev. Litig.* 251 (2006).

(n69)Footnote 69. *Tafeen v. Homestore, Inc., 2004 Del. Ch. LEXIS 38, at *25-*27* (Mar. 22, 2004) .

(n70)Footnote 70. *Homestore, 2004 Del. Ch. LEXIS 38, at *29* .

(n71)Footnote 71. *Tafeen v. Homestore, Inc., 2004 Del. Ch. LEXIS 156, at *6-*9* (Oct. 27, 2004) (unpublished).

(n72)Footnote 72. *Homestore, 2004 Del. Ch. LEXIS 156, at *8-*9* .

(n73)Footnote 73. *See Homestore, Inc. v. Tafeen*, 888 A.2d 204, 209 (Del. 2005) (citing Final Order and Judgment dated April 27, 2005).

(n74)Footnote 74. *See Tafeen v. Homestore, Inc., 2005 Del. Ch. LEXIS 77* (May 26, 2005) (unpublished), *aff'd Homestore, Inc. v. Tafeen*, 886 A.2d 502 (Del. 2005) .

(n75)Footnote 75. *See Del. Code Ann. tit. 8, § 145(k)* (2009).

(n76)Footnote 76. Section 145(k) authorizes the Delaware Court of Chancery to treat advancement rights as summary in nature "because the immediate advancement of fees fulfills a real and legitimate need of those who serve as directors and officers of Delaware corporations when faced with the significant costs of defending legal actions against them." *Tafeen v. Homestore, Inc., 2005 Del. Ch. LEXIS 77, at *8* (May 26, 2005) (unpublished), *aff'd Homestore, Inc. v. Tafeen*, 886 A.2d 502 (Del. 2005) .

(n77)Footnote 77. *Homestore, 2005 Del. Ch. LEXIS 77, at *8* .

(n78)Footnote 78. *Homestore, 2005 Del. Ch. LEXIS 77, at *8* .

(n79)Footnote 79. *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005) .

(n80)Footnote 80. *See* Press Release, Homestore, Inc., *Homestore Reaches Settlement Agreement with Former Officer; Limits Exposure to Advancement of Legal Defense Costs* (Feb. 22, 2006), available at <http://news.move.com/phoenix.zhtml?c=192403&p=irol-newsArticle&ID=820685&highlight=>.

(n81)Footnote 81. *See* Stephen A. Radin, "Sinners Who Find Religion": *Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing*, 25 *Rev. Litig.* 251, 255 & 287 (2006) (citations omitted).

(n82)Footnote 82. *951 A.2d 735* (Del. Ch. 2008) .

(n83)Footnote 83. *Barrett*, 951 A.2d at 736.

(n84)Footnote 84. *Barrett*, 951 A.2d at 743.

(n85)Footnote 85. *Barrett*, 951 A.2d at 744.

(n86)Footnote 86. *Barrett*, 951 A.2d at 744.

(n87)Footnote 87. *Barrett*, 951 A.2d at 747.

(n88)Footnote 88. See Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 *Bus. Law.* 573, 581 (1996).

(n89)Footnote 89. *Radiancy, Inc. v. Azar*, 2006 Del. Ch. LEXIS 13, at *2 (Jan. 23, 2006) (unpublished).

(n90)Footnote 90. *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 218 (Del. 2005) .

(n91)Footnote 91. See *Sun-Times Media Group, Inc. v. Conrad M. Black et al.*, 954 A.2d 380 (Del. Ch. 2008) ; *Bergonzi v. Rite Aid Corp.*, 2003 Del. Ch. LEXIS 117 (Nov. 3, 2003) , appeal denied, *Rite Aid Corp. v. Bergonzi*, 836 A.2d 514 (Del. 2003) .

(n92)Footnote 92. *Sun-Times*, 954 A.2d at 385 .

(n93)Footnote 93. The U.S. Supreme Court granted certiorari in this case on May 18, 2009. *Black v. United States*, 2009 U.S. LEXIS 3513 (U.S. May 18, 2009) .

(n94)Footnote 94. *Sun-Times*, 954 A.2d at 397 .

(n95)Footnote 95. 2003 Del. Ch. LEXIS 117 at *7 .

(n96)Footnote 96. *Bergonzi*, 2003 Del. Ch. LEXIS 117, at *7 .

(n97)Footnote 97. *Bergonzi*, 2003 Del. Ch. LEXIS 117, at *7 .

(n98)Footnote 98. *Bergonzi*, 2003 Del. Ch. LEXIS 117, at *9 .

(n99)Footnote 99. *Bergonzi*, 2003 Del. Ch. LEXIS 117, at *9-*10 .

(n100)Footnote 100. *Bergonzi*, 2003 Del. Ch. LEXIS 117, at *10-*11 (citations omitted).

(n101)Footnote 101. *Bergonzi*, 2003 Del. Ch. LEXIS 117, at *11 (citations omitted).

(n102)Footnote 102. Frank Reynolds, *Qwest Pulled Plug on Legal Fees After CEO's Conviction, He Says*, Andrews Publications, June 1, 2007, available at http://news.public.findlaw.com/andrews/bf/cod/20070601/20070601_nacchio.html.

(n103)Footnote 103. Andy Vuong, *Nacchio, Qwest to Split Legal Fees*, The Denver Post, July 31, 2007, available at http://www.denverpost.com/business/ci_6502936.

(n104)Footnote 104. *United States v. Nacchio*, 519 F.3d 1140 (10th Cir. 2008) , rev'd en banc, 555 F.3d 1234 (10th Cir. 2009) .

(n105)Footnote 105. *United States v. Nacchio*, 555 F.3d 1234 (10th Cir. 2009) .

(n106)Footnote 106. Andy Vuong, *Nacchio Petitions to the Supreme Court*, The Denver Post, Mar. 20, 2009, available at http://www.denverpost.com/nacchioarchive/ci_11960871.

(n107)Footnote 107. Andy Vuong, *Recovery of Fees Unlikely for Qwest*, The Denver Post, Feb. 26, 2009, available at http://www.denverpost.com/nacchioarchive/ci_11786961.

(n108)Footnote 108. See discussion in § 5.02 above.

(n109)Footnote 109. Model Bus. Corp. Act Ann. § 8.53(a) (4th ed. 2008).

(n110)Footnote 110. See *Advanced Mining Sys., Inc. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992).

(n111)Footnote 111. See *Advanced Mining*, 623 A.2d at 84. In a series of opinions, the Delaware Court of Chancery issued, and subsequently refused to vacate, a preliminary injunction enjoining a corporation's board of directors from authorizing advancements of litigation expenses to the directors where the directors were unable to demonstrate that they had considered either of these factors. See *Havens v. Attar*, 1997 Del. Ch. LEXIS 12 (Jan. 30, 1997) (unpublished) (issuing injunction); *Havens v. Attar*, 1997 Del. Ch. LEXIS 164 (Sept. 22, 1997) (denying motion to dissolve injunction); *Havens v. Attar*, 1997 Del. Ch. LEXIS 147 (Nov. 5, 1997) (denying motion for reargument to dissolve injunction). The court found that the directors had failed to consider any evidence pertaining to potential litigation expenses, potential damages, or their ability to repay amounts advanced if they were found not to be entitled to indemnification. See *Havens v. Attar*, 1997 Del. Ch. LEXIS 12, at *43-*47 (Jan. 30, 1997) (unpublished). On this basis, the court determined that the plaintiffs would likely be able to establish a breach of the duty of care (thereby rebutting the presumptive protections of the business judgment rule) and that it was unlikely that the defendants, as interested parties, would be able to demonstrate that they had not breached their duty of loyalty and that the advancement decision was entirely fair to the corporation and its stockholders. *Havens*, 1997 Del. Ch. LEXIS 12, at *43-*47.

(n112)Footnote 112. See John Mark Zeberkiewicz & Blake Rohrbacher, *No Surprises: The Mandatory Nature of Mandatory Advancement and Indemnification*, 15 The Corporate Governance Advisor No. 6, at 24 (Nov./Dec. 2007) ("Corporations and their advisors need to think carefully before drafting mandatory advancement provisions."); see also Stephen A. Radin, *"Sinners Who Find Religion": Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing*, 25 Rev. Litig. 251, 290-292 (2006) (stating that boards should "make a business judgment, and periodically revisit that business judgment" with respect to the scope of advancement rights to be granted to directors, officers and others). *Id.* at 291.

(n113)Footnote 113. See, e.g., Amended and Restated Bylaws of The Estee Lauder Companies Inc. (May 8, 2009), available at http://www.sec.gov/Archives/edgar/data/1001250/000110465909031902/a09-13261_1ex3d1.htm. Section 2 of Article VI provides in relevant part:

No advance shall be made by the Corporation if a determination is reasonably and promptly made by a majority vote of disinterested directors, even if the disinterested directors constitute less than a quorum, or (if such a quorum is not obtainable or, even if obtainable, a quorum of disinterested directors so directs) by independent legal counsel in a written opinion, that, based upon the facts known to the Board or counsel at the time such determination is made, the indemnitee has acted in such a manner as to permit or require the denial of indemnification pursuant to the provisions of Section 1 of this Article VI.

(n114)Footnote 114. See William D. Johnston, *Message From Delaware Courts is Unmistakable--'Mandatory' Advance Defense Expenses Means Just That*, Atlantic Coast In-House (Apr. 2006) (stating that "if bylaw or charter provisions or the terms of a separate agreement are really not intended to provide advancement or indemnification 'to the fullest extent permitted by law,' they shouldn't say so or allow for any even arguable ambiguity in that regard.").

(n115)Footnote 115. *Thompson v. The Williams Cos., 2007 Del. Ch. LEXIS 112 (Del. July 31, 2007)* (unpublished).

(n116)Footnote 116. *Thompson, 2007 Del. Ch. LEXIS 112, at *3* .

(n117)Footnote 117. *Thompson, 2007 Del. Ch. LEXIS 112, at *11* ; see also John Mark Zeberkiewicz & Blake Rohrbacher, *No Surprises: The Mandatory Nature of Mandatory Advancement and Indemnification*, 15 *The Corporate Governance Advisor* No. 6 (Nov./Dec. 2007) (discussing case).

(n118)Footnote 118. *Thompson, 2007 Del. Ch. LEXIS 112, at *12* .

(n119)Footnote 119. *948 A.2d 1157 (Del. Ch. 2008)* .

(n120)Footnote 120. *1992 Del. Super. LEXIS 564 (Del. Super. Oct. 8, 1992)* .

(n121)Footnote 121. Troy's bylaws did not contain the relatively common language that the indemnification and advancement rights granted under the bylaws constitute a "contract right" between the company and the indemnitees. The presence of such language could have led to a different result.

(n122)Footnote 122. See *Del. Code Ann. tit. 8, § 145(f)* (effective Aug. 1, 2009); see also Synopsis, House Bill No. 19 (Apr. 10, 2009), available at <http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19?Opendocument>.

(n123)Footnote 123. *541 F.3d 130 (2d Cir. 2008)* , *aff'g 435 F. Supp. 2d 330 (S.D.N.Y. 2006)* .

(n124)Footnote 124. See Memo from Larry D. Thompson, Deputy Attorney General, regarding Principles of Federal Prosecution of Business Organizations (Jan. 30, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

(n125)Footnote 125. See Memo from Larry D. Thompson, Deputy Attorney General, regarding Principles of Federal Prosecution of Business Organizations (Jan. 30, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

(n126)Footnote 126. See Memo from Paul J. McNulty, deputy Attorney General, regarding Principles of Federal Prosecution of Business Organizations (Dec. 13, 2006), available at http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf.

(n127)Footnote 127. See Principles of Federal Prosecution of Business Organizations (Aug. 28, 2008), available at <http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf>.

(n128)Footnote 128. *Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82 (Del. Ch. 1992)* .

(n129)Footnote 129. *Advanced Mining, 623 A.2d at 84* .

(n130)Footnote 130. *Advanced Mining, 623 A.2d at 84* (by contrast, when a corporation extends indemnification rights, it makes a decision to be legally liable for indemnifiable amounts, and the right to be indemnified for expenses exists--or does not exist--depending upon factors that are independent of a decision to advance expenses); see also *Fasciana v. Electronic Data Sys. Corp., 2003 Del. Ch. LEXIS 19, at *36 n.50 (Feb. 27, 2003)* (citing *Advanced Mining*).

(n131)Footnote 131. *Advanced Mining, 623 A.2d at 84* .

(n132)Footnote 132. Model Bus. Corp. Act Ann. § 8.58(a) (4th ed. 2008). Section 8.58(a) provides that:

A corporation may, by a provision in its articles of incorporation or bylaws or in a resolution

adopted or a contract approved by its board of directors or shareholders, obligate itself in advance of the act or omission giving rise to a proceeding to provide indemnification in accordance with section 8.51 or advance funds to pay for or reimburse expenses in accordance with section 8.53. Id. ... Any such provision that obligates the corporation to provide indemnification to the fullest extent permitted by law shall be deemed to obligate the corporation to advance funds to pay for or reimburse expenses in accordance with section 8.53 to the fullest extent permitted by law, unless the provision specifically provides otherwise.

Section 8.58(a) is intended to prevent the result in *Advanced Mining*. Model Bus. Corp. Act Ann. § 8.58(a) official cmt. (4th ed. 2008). *See also Barry v. Barry*, 28 F.3d 848, 850-851 (8th Cir. 1994) (affirming lower court opinion that contractual provision mandating indemnification to the extent provided under Minnesota law also incorporated a right to mandatory advancement of expenses). The Minnesota indemnification statute makes both indemnification and advancements mandatory unless a corporation opts out of the statutory scheme. *See Minn. Stat. § 302A.521 subds. 2 & 3* (2008).

(n133)Footnote 133. *See § 5.03[8] and [9] below.*

(n134)Footnote 134. *Happ v. Corning, Inc.*, 466 F.3d 41 (1st Cir. 2006) .

(n135)Footnote 135. *Happ*, 466 F.3d at 43 .

(n136)Footnote 136. *Happ*, 466 F.3d at 42 .

(n137)Footnote 137. *Happ*, 466 F.3d at 45-46 .

(n138)Footnote 138. *Happ*, 466 F.3d at 46 .

(n139)Footnote 139. Securities Exchange of 1934 (the "1934 Act") § 13(k)(1), *codified at 15 U.S.C. § 78m(k)* (2008).

(n140)Footnote 140. *See, e.g., Martin Lipton et al., Advising the Audit Committee Today*, 11 The Corporate Governance Advisor No. 3, at 1, 6-7 (May/June 2003); Stephen J. Weiss, *Does Sarbanes-Oxley Gore Your Coverage?*, 27 Directors & Boards 2 (Winter 2003).

(n141)Footnote 141. *See Tafeen v. Homestore, Inc.*, 2004 Del. Ch. LEXIS 38, at *36-*41 (Mar. 22, 2004) .

(n142)Footnote 142. *Envirokare Tech, Inc. v. Pappas*, 420 F. Supp. 2d 291 (S.D.N.Y. 2006) .

(n143)Footnote 143. *See Alston & Bird LLP et al., Sarbanes-Oxley Act, Interpretive Issues Under § 402--Prohibition of Certain Insider Loans* (Oct. 15, 2002), available at http://content.lawyerlinks.com/sec/directors_officers/pdfs/soxact_402_25_firm_mailing.pdf; reprinted at 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:6 (May. 2006).

(n144)Footnote 144. *See Alston & Bird LLP et al., Sarbanes-Oxley Act, Interpretive Issues Under § 402--Prohibition of Certain Insider Loans* 5 (Oct. 15, 2002); *see also* 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:5[A] (May. 2006).

(n145)Footnote 145. *See Alston & Bird LLP et al., Sarbanes-Oxley Act, Interpretive Issues Under § 402--Prohibition of Certain Insider Loans* 5 (Oct. 15, 2002); *see also* 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:5[A] (May. 2006).

(n146)Footnote 146. *See Alston & Bird LLP et al., Sarbanes-Oxley Act, Interpretive Issues Under §*

402--Prohibition of Certain Insider Loans 5 (Oct. 15, 2002); see also 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:5[A] (May. 2006).

(n147)Footnote 147. 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:5[A] (May. 2006).

(n148)Footnote 148. 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:5[A] (May. 2006).

(n149)Footnote 149. See Alston & Bird LLP *et al.*, *Sarbanes-Oxley Act, Interpretive Issues Under § 402--Prohibition of Certain Insider Loans* 5 (Oct. 15, 2002); see also 2 John T. Bostelman, *The Sarbanes-Oxley Deskbook* § 13:2:5[A] (May. 2006).

(n150)Footnote 150. See Mark A. Sargent & Dennis R. Honabach, *D&O Liability Handbook: Law-Sample Documents-Forms* (Thomson West 2009) (compiling and discussing nonexclusivity provisions of various jurisdictions).

(n151)Footnote 151. *Del. Code Ann. tit. 8, § 145(f)* (2009).

(n152)Footnote 152. *But see PepsiCo, Inc. v. Continental Cas. Co.*, 640 F. Supp. 656, 661 (S.D.N.Y. 1986) (interpreting Delaware General Corporation Law Sections 145(a) and (b)). In *PepsiCo*, the court considered whether a decision to indemnify the company's directors comported with Section 145(d) of the Delaware General Corporation Law where the decision was not approved in accordance with the procedures set forth in that section and did not involve any evaluation as to whether the statutory standard of conduct had been met. The court concluded that the failure to comply with Section 145(d) was "made irrelevant by the fact that these provisions are not exclusive conditions for indemnification"; rather, they are simply " 'fall back' provisions which a Delaware corporation may or may not adopt." *PepsiCo, Inc.*, 640 F. Supp. at 661 . *PepsiCo, Inc.* had a bylaw provision requiring it to provide indemnification "to the full extent permitted by law." According to the court, because the bylaw made indemnification of the company's directors and officers the rule rather than the exception, the company had "supplanted the 'backstop' provisions included in [Sections 145(a) and (b)]." *PepsiCo, Inc.*, 640 F. Supp. at 661 . The court determined that the procedures in Section 145(d) "apply only when a corporation indemnifies pursuant to those backstop provisions." *PepsiCo, Inc.*, 640 F. Supp. at 661 . See also *Heffernan v. Pacific Dunlop GNB Corp.*, 1993 U.S. Dist. LEXIS 5, at *15 (N.D. Ill. Jan. 5, 1993) (citing Delaware's nonexclusivity provision, Illinois court interpreting Delaware law concluded that Delaware statutory law "does not mark the exclusive ambit of indemnification rights" and statutory indemnification rights "co-exist with" rights conferred under corporate bylaws).

(n153)Footnote 153. See *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823 (Del. 1992) .

(n154)Footnote 154. *Citadel Holding*, 603 A.2d at 823 (citation omitted). See also *Mooney v. Willys-Overland Motors, Inc.*, 204 F.2d 888, 896 (3d Cir. 1953) (Third Circuit, applying Delaware law, holding contractual rights to indemnification enforceable if supported by an "independent legal ground" but suggesting that scope of indemnification rights may be subject to "realistic limits"); John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 4:21 (Thomson West 2003 (revision by Jennifer Berger & Mitchell A. Kaufman)) (stating that the "realistic limits" language in *Mooney* "may serve as a warning to those who would rely on overly aggressive indemnity agreements").

(n155)Footnote 155. *Waltuch v. ContiCommodity Services, Inc.*, 88 F.3d 87 (2d Cir. 1996) .

(n156)Footnote 156. *Waltuch*, 88 F.3d at 91 . See also S. Samuel Arshat, *Indemnification Under Section 145 of the Delaware General Corporation Law*, 3 *Del. J. Corp. L.* 176, 176-77 (1978), quoted in *Waltuch*, 88 F.3d at 91 n.7 (emphasis added) ("Subsection (f) [of Section 145] permits additional rights to be created, but it is not a blanket authorization to indemnify directors against all expenses, fines, or settlements of whatever nature and regardless of the directors' conduct. The statutory language is circumscribed by the limits of public policy.").

(n157)Footnote 157. *Waltuch*, 88 F.3d at 93. "[T] here would be no point to the carefully crafted provisions of

Section 145 spelling out the permissible scope of indemnification under Delaware law if subsection (f) allowed indemnification in additional circumstances without regard to these limits. The exception would swallow the rule." *Waltuch*, 88 F.3d at 91 (quoting *Waltuch v. Conticommodity Services, Inc.*, 833 F. Supp. 302, 309 (S.D.N.Y. 1993)).

(n158)Footnote 158. *Waltuch v. ContiCommodity Services, Inc.*, 88 F.3d 87, 95 (2d Cir. 1996) .

(n159)Footnote 159. See, e.g., *Mayer v. Executive Telecard, Ltd.*, 705 A.2d 220, 224 & n.6 (Del. Ch. 1997) (concurring with the Second Circuit's construction of Section 145 that a Delaware corporation lacks the power to indemnify a party who did not act in good faith); see also *Morgan v. Grace*, 2003 Del. Ch. LEXIS 113, at *12 & n.20 (Oct. 29, 2003) (citing *Mayer*) ("It is easy to imagine legal limitations on the obligation created by [the contract] that depend upon the nature of the conduct involved. For example, the court presumes that the duty to pay fees and expense[s] would not extend to a case where the defendants are shown to have engaged in intentionally fraudulent or illegal conduct."); *VonFeldt v. Stifel Fin. Corp.*, 1999 Del. Ch. LEXIS 131, at *5-*9 (June 11, 1999) ("While § 145(f) permits indemnification on terms other than as set forth in the rest of § 145, such other indemnification must be consistent with the policies expressed in the other parts of § 145.").

(n160)Footnote 160. *But see Va. Code Ann. § 13.1-704(B)* (2009) (Virginia's statutory nonexclusivity provision). As under Delaware law, Virginia law permits corporations to provide indemnification if an individual acted in good faith. *Va. Code Ann. § 13.1-697(A)* (2009). However, Virginia's nonexclusivity provision establishes a separate and independent basis for granting additional indemnification and advancement rights (beyond those expressly granted by statute) that is not subject to satisfaction of this good faith standard. The nonexclusivity provision authorizes Virginia corporations to provide further indemnification and advancement rights in their articles of incorporation or a stockholder-approved bylaw, except in cases of willful misconduct or a knowing violation of criminal law. *Va. Code Ann. § 13.1-704(B)* (2009).

(n161)Footnote 161. In addition, the corporation statutes of some states require companies to report in writing to their stockholders on modifications to indemnification rights, and on indemnification payments and advances made to directors and officers. See, e.g., *Md. Code Ann., Corps. & Ass'ns § 2-418(l)* (2008) (reporting of indemnification and advances paid to directors in suits by or in the right of a corporation); *N.Y. Bus. Corp. L. §§ 725(c) & (d)* (2000) (reporting of any expenses and other amounts paid by way of indemnification and of actions taken by bylaw amendment, board resolution or agreement with respect to indemnification of directors and officers). This reporting usually occurs in a company's annual proxy statement 42. See, e.g., Xerox Corporation 2009 Annual Proxy Statement (Apr. 9, 2009), available at http://www.sec.gov/Archives/edgar/data/108772/000120677409000706/xerox_def14a.htm (stating that, since the company last reported to stockholders, the company had advanced an aggregate of approximately \$5 million in legal fees and expenses to present and former directors and officers involved in various litigation).

(n162)Footnote 162. See, e.g., *Advanced Mining Sys., Inc. v. Fricke*, 623 A.2d 82, 83 (Del. Ch. 1992) ("virtually all public corporations have by by-law exercised the authority recognized by Section 145 so as to mandate the extension of indemnification rights in circumstances in which indemnification would be permissible under Section 145").

(n163)Footnote 163. *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 560-562 (Del. 2002) . In reaching its decision, the court noted that "corporations will not be unduly punished by this result. They remain free to tailor their indemnification bylaws to exclude 'fees on fees,' if that is a desirable goal." *Stifel*, 809 A.2d at 561-562 . *But see Baker v. Health Mgmt. Sys., Inc.*, 98 N.Y.2d 80, 745 N.Y.S.2d 741, 772 N.E. 2d 1099 (N.Y. 2002) (director or officer is not entitled to indemnification for legal expenses incurred in obtaining indemnification, even if director or officer was successful in underlying action--unless corporation's bylaws, insurance policy or agreements with director or officer explicitly provide for indemnification of fees on fees).

(n164)Footnote 164. See, e.g., *Mayer v. Executive Telecard, Ltd.*, 705 A.2d 220 (Del. Ch. 1997) .

(n165)Footnote 165. See, e.g., *Fasciana v. Electronic Data Sys. Corp.*, 829 A.2d 178, 183 (Del. Ch. 2003)

(individual who won limited right to advancement of defense costs in action under Section 145 was entitled to indemnification for portion of litigation expenses incurred in enforcing right to advancement).

(n166)Footnote 166. See *Weaver v. ZeniMax Media, Inc.*, 2004 Del. Ch. LEXIS 10 (Jan. 30, 2004) (concluding that corporate officer and director was entitled to fees on fees in an advancement action where the corporation's bylaws provided mandatory advancement of actual and reasonable expenses and did not specifically exclude fees on fees, even though the bylaws did not specify that indemnification or advancement would be provided "to the full extent authorized by law").

(n167)Footnote 167. *Weaver*, 2004 Del. Ch. LEXIS 10, at *27 .

(n168)Footnote 168. *Weaver*, 2004 Del. Ch. LEXIS 10, at *24- *26 .

(n169)Footnote 169. See *Levy v. HLI Operating Co., Inc.*, 924 A.2d 210 (Del. Ch. 2007) .

(n170)Footnote 170. *Levy*, 924 A.2d at 222 .

(n171)Footnote 171. *Levy*, 924 A.2d at 226 ; see also John Mark Zeberkiewicz & Blake Rohrbacher, *No Surprises: The Mandatory Nature of Mandatory Advancement and Indemnification*, 15 The Corporate Governance Advisor No. 6, at 23 (Nov./Dec. 2007) (discussing case).

(n172)Footnote 172. 2008 Del. Ch. LEXIS 82 (Del. Ch. June 23, 2008) .

(n173)Footnote 173. *Jackson Walker*, 2008 Del. Ch. LEXIS 82 at 36 .

(n174)Footnote 174. 2008 Del. Ch. LEXIS 60 (Del. Ch. May 23, 2008) (unpublished).

(n175)Footnote 175. *Zaman*, 2008 Del. Ch. LEXIS at 35-36.

(n176)Footnote 176. See, e.g., *Del. Code Ann. tit. 8, § 145(j)* (2009). Section 145(j) generally provides that indemnification continues after an individual has ceased to be a director, officer, employee or agent of a corporation, and inures to the benefit of the individual's heirs, executors and administrators.

(n177)Footnote 177. See discussion in § 5.03[4] above.

(n178)Footnote 178. See Model Bus. Corp. Act Ann. § 8.51 statutory comparison (4th ed. 2008) (surveying extent to which indemnification statutes of various jurisdictions permit indemnification in derivative suits).

(n179)Footnote 179. See § 5.03[4] above.

(n180)Footnote 180. See § 5.03[7] above.

(n181)Footnote 181. See *Del. Code Ann. tit. 8, § 145(e)* (2009).

(n182)Footnote 182. See *Waltuch v. ContiCommodity Services, Inc.*, 88 F.3d 87, 94 (2d Cir. 1996) (citing E. Norman Veasey *et al.*, *Delaware Supports Directors With a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 *Bus. Law.* 399, 415 (1987)); see also 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.12[E] (3d ed. Supp. 2009). "Fees on fees" are discussed in § 5.03[8] above.

(n183)Footnote 183. See, e.g., *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823 (Del. 1992) (citation omitted) ("Private parties may not circumvent the legislative will simply by agreeing to do so.").

(n184)Footnote 184. See § 5.03[7] above (discussing nonexclusivity provision of Delaware indemnification

statute).

(n185)Footnote 185. *See, e.g., Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 893-96 (3d Cir. 1953)* (Third Circuit, applying Delaware law, rejected argument that Delaware indemnification statute and corporate bylaw should control indemnification to the exclusion of all other arrangements and held that indemnification rights set forth in severance agreement were enforceable as long as rights were supported by an "independent legal ground."). *See also* Ronald E. Mallen & David W. Evans, *Surviving the Directors' and Officers' Liability Crisis: Insurance and the Alternatives*, 12 *Del. J. Corp. L.* 439, 465 (1987) ("Although what constitutes an 'independent legal ground' may be susceptible of varying interpretations, some form of consideration, stockholder approval or demonstrable benefit to the corporation would probably have to be shown.").

(n186)Footnote 186. The risks inherent in the possibility of unilateral amendment were clearly illustrated by *Schoon v. Troy Corp.*, a 2008 decision in which the Delaware Court of Chancery held that a former director was not entitled to advancement where, subsequent to the director's departure from the company's board, the board amended the bylaws to eliminate advancement rights for former directors. *See Schoon v. Troy Corp., 948 A.2d 1157 (Del. Ch. 2008)*, and § 5.03[5] above for a discussion of *Schoon*.

(n187)Footnote 187. *See* § 5.03[5] above (discussing *Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82 (Del. Ch. 1992)*) and § 5.03[8] above (discussing fees on fees).

(n188)Footnote 188. *See* § 5.03[5] above for a discussion of bylaw provisions giving the board or another appropriate decision-maker discretion to cut off advancement rights to so-called "bad actors."

(n189)Footnote 189. *See, e.g.,* Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 *DePaul Bus. & Comm. L.J.* 295 (Winter 2004).

(n190)Footnote 190. D&O insurance is discussed in § 5.04 below.

(n191)Footnote 191. *See Del. Code Ann. tit. 8, § 145(g)* (2009).

(n192)Footnote 192. *See* discussion in § 5.04[2] below.

(n193)Footnote 193. *See, e.g., La. Rev. Stat. Ann. § 12:83(F)(1)* (2008) (authorizing creation of "a trust fund or other form of self-insurance arrangement for the benefit of persons indemnified by the corporation"); *Md. Code Ann., Corps. & Ass'ns § 2-418(k)(2)* (2008) (authorizing protection "similar" to insurance, "including a trust fund, letter of credit, or surety bond"); *Nev. Rev. Stat. § 78.752(2)* (2009) (authorizing creation of "other financial arrangements" on behalf of indemnitees, including creation of a trust fund, establishment of a program of self-insurance, the "securing of [the corporation's] obligation of indemnification by granting a security interest or other lien on any assets of the corporation," and "establishment of a letter of credit, guaranty or surety"); *N.M. Stat. Ann. § 53-11-4.1(J)* (2008) (authorizing "similar protection" to insurance, "including but not limited to providing a trust fund, a letter of credit or self-insurance"); *Ohio Rev. Code Ann. § 1701.13(E)(7)* (2009) (authorizing protection "similar" to insurance, "including, but not limited to, trust funds, letters of credit, or self-insurance"); *15 Pa. Cons. Stat. Ann. § 518(a)* (2008) ("Any domestic corporation may create a fund of any nature, which may, but need not be, under the control of a trustee, or otherwise secure or insure in any manner its indemnification obligations."); *Tex. Bus. Org. Code § 8.151* (2007) (a corporation may, for the benefit of persons indemnified by the corporation: (1) create a trust fund; (2) establish any form of self-insurance; (3) secure its indemnity obligation by grant of a security interest or other lien on the assets of the corporation; or (4) establish a letter of credit, guaranty, or surety arrangement).

(n194)Footnote 194. *See Del. Code Ann. tit. 8, § 145(g)* (2009); § 5.04 below.

(n195)Footnote 195. *See, e.g., La. Rev. Stat. Ann. § 12:83(F)(1)* (2008); *Nev. Rev. Stat. § 78.752(4)* (2009); *Tex.*

Bus. Org. Code § 8.151(f) (2007).

(n196)Footnote 196. Another funding mechanism that, like an indemnification trust, permits corporations to earmark and segregate funds for payment of indemnification and provides for the release of those funds when certain procedures are followed, is a standby letter of credit, which requires a third party, such as a bank, to assume the risk that a corporation will not pay indemnification. See John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 11:5 (Thomson West 2003 (revision by Jennifer Berger & Mitchell A. Kaufman)); see also J. Phil Carlton & M. Guy Brooks, III, *Corporate Director and Officer Indemnification: Alternative Methods for Funding*, 24 *Wake Forest L. Rev.* 53 (1989); Joseph F. Johnston, Jr., *How to Fund Indemnification Arrangements*, 1 *Insights No. 2*, at 3 (Aug. 1987).

(n197)Footnote 197. *Security America Corp. v. Walsh*, 1985 U.S. Dist. LEXIS 23482 (N.D. Ill. Jan. 11, 1985) (applying Delaware law).

(n198)Footnote 198. The trusts were established for the express purpose of preventing the new board from stopping advancement of litigation expenses to outgoing directors, the funds placed in trust constituted approximately one-third of the corporation's total assets, law firms representing the directors in the litigation were named as trustees of the trusts and made payments to themselves for legal services to the directors, and one director had been delegated extensive authority to provide for the payment of the litigation expenses. See *Security America*, 1985 U.S. Dist. LEXIS 23482, at *11 .

(n199)Footnote 199. *Security America*, 1985 U.S. Dist. LEXIS 23482, at *12 .

(n200)Footnote 200. See John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 11:6 (Thomson West 2003 & Supp. 2008-09 (revision by Jennifer Berger & Mitchell A. Kaufman)); J. Phil Carlton & M. Guy Brooks, III, *Corporate Director and Officer Indemnification: Alternative Methods for Funding*, 24 *Wake Forest L. Rev.* 53, 69 n.113 (1989); Joseph F. Johnston, Jr., *How to Fund Indemnification Arrangements*, 1 *Insights No. 2*, at 3, 5-7 (Aug. 1987).

(n201)Footnote 201. See John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 11:6 (Thomson West 2003 & Supp. 2008-09 (revision by Jennifer Berger & Mitchell A. Kaufman)). In the event of bankruptcy, the transfer of assets to the trust could be subject to attack under state fraudulent conveyance statutes and the federal bankruptcy laws. Under the Uniform Fraudulent Transfer Act and its predecessor, the Uniform Fraudulent Conveyance Act, a creditor or trustee in bankruptcy may be able to recover assets transferred by a debtor if the debtor made the transfer without receiving "reasonably equivalent value" ("fair consideration" is the term used in the Uniform Fraudulent Conveyance Act) and the debtor was insolvent at the time of the transfer or became insolvent as a result of it. See Uniform Fraudulent Transfer Act, §§ 4(a)(2) & (5)(a) (2007); Uniform Fraudulent Conveyance Act § 4 (2007). In addition, a transfer may be deemed fraudulent under state law if it was made with actual intent to hinder, delay or defraud creditors. See Uniform Fraudulent Transfer Act, § 4(a)(1) (2007); Uniform Fraudulent Conveyance Act § 7 (2007). Under the federal bankruptcy laws, a trustee may avoid certain pre-bankruptcy transfers by a debtor that occurred within a short period prior to commencement of the bankruptcy case. See 11 U.S.C. § 547(b) (2008). A transfer may also be set aside as fraudulent if it occurred within two years prior to commencement of the bankruptcy case, and it was made with actual intent to hinder, delay or defraud creditors or the debtor received less than reasonably equivalent value and was, or was rendered, insolvent, undercapitalized, or unable to pay its debts as they came due. See 11 U.S.C. § 548(a) (2007).

(n202)Footnote 202. *Askanase v. LivingWell, Inc.*, 45 F.3d 103, 105-06 (5th Cir. 1995) .

(n203)Footnote 203. *Askanase*, 45 F.3d at 106-07 .

(n204)Footnote 204. See *Askanase*, 45 F.3d at 105 .

(n205)Footnote 205. *Askanase*, 45 F.3d at 107 & n.4.

(n206)Footnote 206. Discussed later in this § 5.03[10].

(n207)Footnote 207. See Joseph F. Johnston, Jr., *How to Fund Indemnification Arrangements*, 1 Insights No. 2, at 3, 7 & n.13 (Aug. 1987) (citing *Anesthesia Service Medical Group, Inc. v. Commissioner*, 1985 U.S. Tax Ct. LEXIS 5, *aff'd*, 825 F.2d 241 (9th Cir. 1987)) (where professional corporation established and funded a trust to provide malpractice protection to employees, there was no shifting of the risk of loss and corporation could not deduct its contributions to the trust as an insurance expense).

(n208)Footnote 208. See *La. Rev. Stat. Ann. § 12:83(F)(1)* (2007); *Md. Code Ann., Corps. & Ass'ns § 2-418(k)(2)* (2007); *Nev. Rev. Stat. § 78.752(2)* (2005); *N.M. Stat. Ann. § 53-11-4.1(J)* (2007); *Ohio Rev. Code Ann. § 1701.13(E)(7)* (2007); *15 Pa. Cons. Stat. Ann. § 518(a)* (2007); *Tex. Bus. Org. Code § 8.151(b)-(c)* (2007).

(n209)Footnote 209. See, e.g., Fred T. Podolsky & Susanne Murray, Hilb Rogal & Hobbs, *2005 Directors and Officers Liability Snapshot and Insurance Market Forecast 15*, available at <http://www.directorsandboards.com/DBEBRIEFING/JANUARY2005/DO2005FORECAST.PDF> ("In addition to [supplemental insurance coverage] alternatives, many companies are considering how they might use a captive insurance company to insure some of their D&O exposure (the indemnifiable parts).").

(n210)Footnote 210. See, e.g., *Helvering v. LeGierse*, 312 U.S. 531, 539, 61 S. Ct. 646, 85 L. Ed. 996 (1941) (holding in the tax context that "historically and commonly insurance involves risk-shifting and risk-distributing").

(n211)Footnote 211. See Donald J. Riggin, *The Evolution of Finite Reinsurance and Financial Accounting Statement (FAS) 113*, Expert Commentary--International Risk Management Institute (May 2008), available at <http://www.irmi.com/expert/articles/2008/riggin05-risk-finance-captives.aspx>.

(n212)Footnote 212. See Donald J. Riggin, *Structured Insurance Programs*, Expert Commentary--International Risk Management Institute (Feb. 2009), available at <http://www.irmi.com/expert/articles/2009/riggin02-risk-finance-captives.aspx>.

(n213)Footnote 213. 924 A.2d 210 (Del. Ch. 2007) .

(n214)Footnote 214. 948 A.2d 1157 (Del. Ch. 2008) .

(n215)Footnote 215. 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008) .

(n216)Footnote 216. See Randall W. Bodner and Peter L. Welsh, *Advancement and Indemnification Update: Sadona v. American Stock Exchange*, 22 Insights No. 9, at 23, 27 (Sept. 2008).



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Corporate Governance: Law and Practice

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CHAPTER 5 LIABILITY OF OFFICERS AND DIRECTORS; STATUTORY LIMITATIONS, INDEMNIFICATION
AND D&O INSURANCE

1-5 Corporate Governance: Law and Practice § 5.04

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§ 5.04 D&O Insurance

[1] Corporate Governance and the D&O Insurance Marketplace

D&O insurance is important in attracting qualified directors. As one court has noted, D&O insurance "plays an important role in corporate governance in America" because "[u]nless directors can rely on the protections given by D&O policies, good and competent men and women will be reluctant to serve on corporate boards."ⁿ¹

Today, directors face a more challenging environment than at any time in recent history--an environment in which there is an increased risk of litigation, the prospect of million dollar judgments in securities class action and derivative lawsuits, and heightened scrutiny from regulators and investors. In this environment, insurance may offer the last source of protection from substantial personal liability if a corporation is unable or unwilling to pay indemnification. The corporate laws of most states provide that corporations have the power to purchase and maintain insurance, at the corporation's expense, on behalf of directors, officers, employees and agents,ⁿ² and to insure these individuals against potential liability even in instances where the corporation may not have the power to indemnify them, such as for claims involving violations of the federal securities laws. Accordingly, insurance can be important in filling the gaps in situations where indemnification is unavailable.

Beginning in the mid-1990s, following the passage of the Private Securities Litigation Reform Act of 1995, D&O insurance premiums fell dramatically and insurers expanded the coverage available under "standard" D&O policies, resulting in significantly more favorable coverage terms at greatly reduced rates.ⁿ³ From 2001 through the end of 2003, this trend reversed, as public companies faced one of the most difficult insurance markets in years. A significant increase in the number of restatements of public company financial statements and the unprecedented wave of scandals at Enron Corp., WorldCom, Inc., Adelphia Communications Corporation, Tyco International Ltd., and HealthSouth Corporation led to increased regulatory investigations and a surge in the number of securities cases against public companies and their officers and directors. At the same time, some suggested that the Private Securities Litigation Reform Act had failed to accomplish its intended purpose of reducing the number of securities lawsuits filed, increasing the number of dismissals at earlier stages of litigation, and lowering settlement costs,ⁿ⁴ thereby contributing to the increase in the frequency and severity of securities claims.ⁿ⁵

Faced with having to absorb the lion's share of massive settlement and defense costs resulting from such litigation, D&O insurers responded with more restrictive coverage terms and substantial premium increases. Although many of the trends that led to the tightening of the D&O insurance market beginning in 2001 have continued, such as increased securities enforcement activity and massive securities class action lawsuits,ⁿ⁶ the market for D&O insurance began to soften in 2004 and coverage restrictions began to ease, with companies generally experiencing lower premiums and retentions and more room to negotiate coverage endorsements.ⁿ⁷ More recently, however, the subprime mortgage meltdown and financial crisis have resulted in significant price increases in the financial services sector, together with a reduction in policy limits and more restrictive policy terms. A similar tightening has not yet occurred in other sectors, though some experts have predicted that it is only a matter of time before the remainder of the market for D&O insurance is impacted.ⁿ⁸ On the whole, public companies still are finding it more difficult than in the past to secure adequate levels of D&O insurance coverage. In this regard, it is expected that the practice of purchasing additional "Side A" coverage for nonindemnifiable losses will continue.

To the extent that D&O insurance is difficult or expensive to obtain, this has ramifications for corporate governance because it reduces the incentive for qualified, talented directors to serve. Directors may have concerns, for example, about whether a company's D&O insurance coverage is sufficient to cover them or about the availability of coverage for particular types of claims.ⁿ⁹ In addition, the quality of a company's corporate governance practices can impact its ability to obtain insurance at a reasonable cost. Following the collapse of Enron Corp. and the series of corporate scandals in its wake, one commentator predicted that companies with "corporate governance red flags may face, at best, bigger premium increases or more restrictive coverage terms on renewal."ⁿ¹⁰ Companies looking to obtain or renew D&O insurance coverage should expect that their corporate governance practices will be subject to scrutiny by insurers.ⁿ¹¹ In this regard, areas that insurers look at to assess risk include a company's overall financial circumstances, accounting practices, governance and executive compensation, stock price volatility, Sarbanes-Oxley compliance, internal controls, insider trading and disclosure practices, including processes for complying with Regulation Fair Disclosure.ⁿ¹² Accordingly, transparent, progressive corporate governance practices may yield tangible benefits for corporations seeking to obtain comprehensive and cost effective D&O insurance coverage.ⁿ¹³

[2] The Role of Insurance

The fundamental purpose of D&O insurance is to shift by contract to an independent third party--the insurance carrier--a portion of the risk arising out of actions taken both by the corporation's officers and directors in their official capacity and by the corporation itself in connection with securities law matters. This is done in several ways. First, the standard "Side A" portion of a primary D&O policyⁿ¹⁴ protects insured directors and officers against certain types of losses against which the corporation does not or cannot indemnify them, including losses arising out of conduct against which a corporation may not have authority to indemnify under state corporate law or the federal securities laws. In response to increased concerns about the availability of coverage for nonindemnifiable losses, many corporations have expanded their Side A coverage in recent years by purchasing additional Side A capacity beyond that available under their primary policy.ⁿ¹⁵

There are a number of circumstances in which indemnification may not be available. For example, a director or officer who is determined not to have acted in good faith and in a manner reasonably believed to be in the corporation's best interests is not eligible for indemnification as a matter of state law.ⁿ¹⁶ Depending on the facts, the D&O policy may cover the cost of defense of, as well as the settlement or judgment resulting from, such allegations, even though the corporation could not indemnify the director.

Indemnification may also be unavailable where a corporation has filed for bankruptcy or is financially troubled, or following a change in control if a new board of directors is unwilling to authorize indemnification of outgoing directors and officers. Similarly, indemnification may be limited in derivative suits. Under Delaware law, for example, if a director or officer is found liable to the corporation, indemnification for expenses is permitted only with court

approval,¹⁷ and it is generally thought that indemnification for judgment and settlement amounts is not available¹⁸ because a corporation would not receive the benefit of those amounts if it were then required to pay them out as indemnification.¹⁹

Finally, state and federal laws, as well as a corporation's organizational documents, may limit the corporation's ability to indemnify for public policy reasons. For example, the SEC and the courts have taken the position that corporations may not indemnify their officials against liability for violating the Securities Act of 1933 Act (the "1933 Act") because permitting indemnification would undermine the policy of the securities laws, which seek "to encourage diligence, investigation and compliance with the requirements of the statute by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages."²⁰ Under Regulation S-K, a company registering securities under the 1933 Act must acknowledge the SEC's position by including disclosure in its registration statement indicating that it has been informed that, in the opinion of the SEC, indemnification of directors and officers for violations of the 1933 Act "is against public policy as expressed in the Act and is therefore unenforceable."²¹ Over the years, some courts have expanded this position to prohibit indemnification for claims based on certain violations of the 1934 Act, particularly violations of the antifraud provisions, as contrary to public policy.²² Since antifraud claims require knowing misconduct, this limitation is consistent with the broader public policy limitations applicable to indemnification under most state laws, which prohibit indemnification for such misconduct. Although the SEC historically has permitted insurance, following several high-profile settlements in recent years in which defendants were able to obtain indemnification and/or insurance coverage for civil fines, the SEC adopted a policy of requiring settling parties to forego any rights they have to indemnification, reimbursement through D&O or other insurance, or favorable tax treatment of civil penalties paid to the SEC in SEC enforcement proceedings.²³

In 2003, after Xerox Corporation announced its intention to indemnify several executives in a settlement with the SEC,²⁴ then-SEC Chairman William Donaldson expressed "concern" about "companies that, under permissive state laws, indemnify their officers and directors against disgorgement and penalties ordered in law enforcement actions, including those brought by the [SEC]," saying that it "just isn't good public policy" and is "an area in which [the SEC] may need to consider ways to bring about reform."²⁵ Since then, the SEC has required, as a condition of settlement in enforcement proceedings, that directors and others agree not to seek or accept indemnification, or reimbursement from any source (including D&O insurance), for civil monetary penalties.²⁶ For example, in the SEC's enforcement action against Lucent Technologies Inc. arising out of the improper recognition of over \$1 billion in revenue,²⁷ Lucent and three settling individual defendants agreed not to seek or accept reimbursement or indemnification from any source, including, but not limited to, insurance, with regard to any civil penalties. What was also noteworthy about the *Lucent* proceeding, however, was the SEC's imposition of a \$25 million penalty for Lucent's failure to cooperate that was based in part on Lucent's decision to provide indemnification to certain employees in connection with the settlement, a decision that the SEC viewed as against public policy:²⁸

After reaching an agreement in principle with the staff to settle the case, and without being required to do so by state law or its corporate charter, Lucent expanded the scope of employees that could be indemnified against the consequences of this SEC enforcement action. Such conduct is contrary to the public interest.

In a public statement, an SEC official explained that, in the SEC's view, "Lucent's offer to pick up the legal tab for employees who would not normally be covered by such benefits was equivalent to handing these employees 'a blank check to litigate with us, with no consequences.'"²⁹ Accordingly, under the SEC's current policy, civil penalties assessed against an individual in an SEC enforcement proceeding must be personally paid by the individual. To date, the SEC has not directly addressed whether amounts other than civil penalties, such as insider trading profits disgorged under equitable remedies, may be reimbursed through indemnification or insurance. However, most D&O insurance policies do not cover disgorgement of insider trading profits or of payments to which directors or officers are determined not to have been entitled.³⁰

Finally, it is possible that some violations of the Sarbanes-Oxley Act could result in a director or officer being deemed not to have acted in good faith. This, in turn, could result in those violations not being indemnifiable under state law, although the extent to which some Sarbanes-Oxley violations would be covered under a company's D&O insurance policy remains unclear.ⁿ³¹ For example, indemnification could be unavailable for violations of Sarbanes-Oxley Act provisions relating to:

- improper influence on the conduct of an audit;ⁿ³²
- disgorgement of officer compensation and trading profits following a restatement;ⁿ³³
- false certifications by officers;ⁿ³⁴
- trading during pension fund blackout periods;ⁿ³⁵
- knowingly destroying or falsifying corporate documents;ⁿ³⁶ and
- retaliating against whistleblowers.ⁿ³⁷

Insurance may also be subject to public policy limitations,ⁿ³⁸ although the availability of indemnification varies from state to state and corporation to corporation. For this reason, insurance may provide an alternative source of payment. Nevertheless, D&O insurance policies generally exclude payment for intentional fraud and some D&O policies' standard "Side A" coverage explicitly excludes payment for violation of the federal securities laws. Therefore, to the extent that the company's objective is to protect directors and officers for losses resulting from certain violations of the federal securities laws because it cannot directly indemnify them for such losses, it is important to read the policy exclusions carefully and to understand the extent to which, after the exclusions are taken into account, a D&O policy is really likely to fill any gaps.ⁿ³⁹

D&O insurance can also serve as an important source of protection for the corporation itself. "Side B" of the typical D&O policy compensates a corporation for expenses that it incurs as a result of indemnifying directors and officers and that, in the absence of insurance, would have to be paid out of corporate funds. In addition, beginning in the mid-1990's, there was a broadening of coverage under many policy forms to provide so-called "entity" coverage. Entity coverage protects the corporation from claims--such as securities claims--that are brought directly against the corporation.

The existence of entity coverage has given rise to increasing concern about the continued availability of D&O insurance coverage for directors and officers in the bankruptcy context and the adequacy of coverage amounts available for these individuals because the D&O insurance is shared with the company.ⁿ⁴⁰ At the same time, financial restatements and corporate scandals have heightened awareness of the risk that insurers may seek to deny or rescind coverage. In response to these realities, corporations increasingly are relying on multiple layers of coverage to protect their directors and officers. This coverage typically takes the form of a so-called "Side A tower" of coverage that is in addition to the standard Side A, Side B and entity coverage. It protects directors and officers only and is not shared with the company. Insurers have also begun offering individual director liability insurance policies, which can be purchased either by a corporation or by directors themselves, as well as policies targeted to retired directors and officers.ⁿ⁴¹

[3] Important Features of Insurance Coverage

[a] Structure of a Typical Policy

Although D&O insurance policies vary in their form and language, modern policies typically consist of three possible insuring clauses or insuring agreements that establish the scope of coverage to be provided by the insurer. The first of the insuring clauses, known as "Side A" or "individual side" coverage, provides coverage to officers and directors for

losses they incur that are not indemnified by the corporation.ⁿ⁴² The second of the insuring clauses, known as "Side B" or indemnification coverage, provides coverage to the corporation for losses incurred as a result of paying indemnification to officers and directors. The third clause, which is found in some but not all policies, provides "entity" coverage, which provides insurance to a corporation for claims that are brought directly against it. In public company D&O policies, entity coverage generally is limited to securities claims, while for other types of organizations, such as private companies and nonprofit organizations, it often extends to a broader range of claims against an organization. A typical policy also contains definitions of important terms, exclusions from coverage, and endorsements (a series of agreements in addition to those contained in the body of the main insurance policy that address matters such as additional coverage, exclusions, conditions and adjustments to the premium).

Within the parameters of the insuring clauses described above, D&O insurance policies generally cover "losses" incurred by an insured resulting from "claims" made against the insured arising out of the insured's "wrongful acts."

[b] Claims

D&O insurance policies are "claims-made" policies, which means that they provide coverage only for claims that are first made against the insured director or officer during the policy term. A "claim" refers to a demand by a third party against the insured seeking to hold the insured responsible for the consequences of an allegedly wrongful act. The claim is "made" when the officer or director receives or learns of it. Most policies also require that the insured officers and directors report claims to the insurer within the policy period or within a relatively short period of time (such as 60 days) after the coverage period, although the standard D&O policy also provides for "tail" or extended reporting coverage whereby, for a specified additional premium, the carrier will honor claims reported under the policy for an additional specified period of time.

To avoid potential ambiguities, policies typically contain a definition of "claim," which generally covers civil proceedings, post-indictment criminal proceedings, and administrative proceedings (after receipt or filing of a notice of charges), and monetary or nonmonetary damages or relief for any of these types of proceedings. The definition of "claim" may also include civil, criminal, administrative or regulatory investigations and grand jury proceedings against an insured for a wrongful act, although most D&O insurance policies do not provide coverage for the initial stages of an investigation.ⁿ⁴³ The definition of "claim" can be critical because D&O policies generally do not cover defense costs until a matter ripens into a "claim."

[c] Wrongful Acts

As discussed above, D&O policies provide coverage for losses resulting from claims made against an insured arising out of the insured's "wrongful acts." A "wrongful act" is typically defined to include:

any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted, by any Insured Person, individually or otherwise, in his Insured Capacity, or any matter claimed against him solely by reason of his serving in such Insured Capacity.ⁿ⁴⁴

The definition of "wrongful act" can be critical in determining the scope of coverage available under a D&O insurance policy. Some courts have concluded that language defining a "wrongful act" as "any negligent act, error, omission, misstatement or misleading statement" did not extend to cover intentional--as opposed to merely negligent--wrongful acts.ⁿ⁴⁵ In addition, losses resulting from intentional wrongful acts are often specifically excluded from coverage.

Directors and officers frequently act in a number of capacities vis-a-vis a corporation. In addition to being directors or officers, they may be stockholders or they may act as a fiduciaries for benefit plans.ⁿ⁴⁶ The definition of "wrongful act" in D&O policies generally requires, as a condition of coverage, that an individual be acting in the capacity of a director

or officer. Courts have typically taken the position that coverage is not available for claims against directors and officers for wrongful acts that do not relate to their corporate duties.ⁿ⁴⁷ Accordingly, if a director or officer of an insured corporation serves, at the corporation's request, as a director or officer of another corporation that is not a subsidiary of the corporation, the D&O policy of the insured corporation would not cover claims arising out of that service unless such coverage were specifically provided in the policy. Coverage for service at outside entities is commonly provided by endorsement and may be incorporated into the definition of "wrongful act." Other claims that would fall outside the definition of "wrongful act" because an individual is not acting in the capacity as a director or officer include claims arising out of the provision of professional services (such as legal or consulting services) to a corporation and insider trading.

[d] Losses

In order to be eligible for coverage, an insured that is the subject of a claim arising out of a wrongful act must suffer a "loss." Where the insured is an individual, such as a director or officer, a loss is generally defined as any amount for which the insured is legally liable and that arises out of a "claim" made against the insured for a wrongful act. Costs of defense are either included in the definition of loss or provided as a separate element of the coverage. Where the insured is a corporation, under the "Side B" coverage of the D&O insurance policy, a "loss" would include any amount for which the corporation indemnifies directors or officers for their respective wrongful acts, and, if entity coverage is included in the policy, any losses the corporation incurs arising out of claims brought directly against it, as well as the costs of defense. Coverage for "losses," including defense costs, is often predicated on the existence of a "claim," which may or may not include investigations, particularly in their preliminary stages.ⁿ⁴⁸ Such coverage will depend on the wording of the particular policy. In addition, in some D&O policies, the definition of "defense costs" includes fees and expenses incurred in the "investigation, defense and/or appeal" of a "claim," although many other D&O policies include within that definition only fees and expenses incurred in "defending" a "claim." Accordingly, costs incurred in responding to a regulatory investigation (at least in the initial stages) or in conducting an internal investigation may not be covered under a D&O policy, even though these costs may be substantial. Since directors and officers may expect the corporation to cover costs they incur in responding to investigations, corporations should understand the scope of coverage available for investigation costs under a D&O policy and negotiate for the broadest coverage possible in this area.

The definition of "loss" in D&O policies typically incorporates a number of exceptions, the most common of which are for failure to pay taxes,ⁿ⁴⁹ fines and penalties,ⁿ⁵⁰ and other matters deemed uninsurable under the law pursuant to which the policy is construed,ⁿ⁵¹ including punitive damages.ⁿ⁵² As a practical matter, the fact that most claims against directors and officers are either settled or dropped, and thus do not result in judgments, minimizes the impact of the exclusion for punitive damages on director and officer liability. The general theory behind excluding coverage for punitive damages under D&O insurance policies (as well as other types of insurance policies) is that punitive damages--much like fines and penalties--are designed to punish wrongdoers and allowing wrongdoers to shift liability for punitive damages to an insurance company fails to punish them or to deter similar undesirable conduct in the future.ⁿ⁵³ Where the language of an insurance policy does provide coverage for punitive damages--which, as noted above, most D&O policies do not--the relevant inquiry shifts to whether coverage is prohibited on public policy grounds. This is a matter of state law, which means that the availability of insurance depends on the public policy of the state whose law governs the insurance contract.ⁿ⁵⁴

[e] Notice

D&O insurance policies typically specify that insureds must give the insurer notice when they receive a claim or become aware of facts that may result in a claim. The result in *Country Mutual Insurance Co. v. Livorsi Marine, Inc.*ⁿ⁵⁵ highlights the importance of providing insurers with prompt notice of potential and actual claims. In this case, the insurer faced a somewhat unusual situation because two corporations, both of which it insured, had sued each other for trademark infringement, but more than one and a half years passed before either insured tendered notice to the

insurer.ⁿ⁵⁶ The insurer denied coverage to both corporations on the basis of lack of proper notice under the policy. The corporations argued that the failure to notify the insurer had caused it no prejudice since both corporations used the insurer. The insurer argued that failure to notify for over one-and-a-half years was unreasonable as a matter of law, and that the corporations had no justification or other defense as to why they had failed to notify the insurer.ⁿ⁵⁷ The court in *Country Mutual* considered prejudice to the insurer, but noted that this was only one factor among many that required evaluation, including the lack of notice language in the policy, the policyholder's business and insurance sophistication, awareness of events that would be covered and whether the insured exercised diligence in considering whether coverage was available.ⁿ⁵⁸ After weighing these factors, the court found that because the insurer did not receive reasonable notice, the corporations were barred from recovering under the policy, "regardless of whether the lack of reasonable notice prejudiced the insurer."ⁿ⁵⁹

The Texas Supreme Court, however, reached a contrary result in 2009 in *Prodigy Communications Corp. v. Agricultural Excess and Surplus Insurance Co.*, holding that a failure to give notice "as soon as practicable" will not result in a loss of coverage unless the insurer is prejudiced by the failure.ⁿ⁶⁰ The *Prodigy* case involved a D&O insurance policy that contained a notice provision requiring, "as a condition precedent" to the insured's rights under the policy, that the insured give notice of any claim to the insurer "as soon as practicable ... but in no event later than ninety (90) days after the expiration of the Policy Period, or Discovery Period."ⁿ⁶¹ *Prodigy* learned of a claim on June 20, 2002, but did not notify its insurer until nearly a year later (though prior to the expiration of the discovery period), on June 6, 2003. The court analyzed the rationale for requiring notice in a "claims-made" policy, such as a D&O insurance policy, and concluded that requiring notice within the policy period or a specified period of time thereafter was an essential part of the bargained-for exchange between an insurer and its insured, but that requiring notice to be given "as soon as practicable" was not essential.ⁿ⁶² On that basis, the court held that "[i]n a claims-made policy, when an insured notifies its insurer of a claim within the policy term or other reporting period that the policy specifies, the insured's failure to provide notice 'as soon as practicable' will not defeat coverage in the absence of prejudice to the insurer."ⁿ⁶³

To avoid difficulties, an insured should give notice to both its broker and insurer in accordance with the policy terms as soon as practicable after learning of a claim in order to avoid difficulties. Failure to do so may result in coverage questions, a lengthy or expensive trial or worse, in the denial of coverage.

[f] Insurers' Consent to Settlement

D&O insurance policies typically contain a provision requiring the consent of the insurer before an insured enters into a settlement, often coupled with a proviso that consent may not be "unreasonably withheld." In a 2008 case, a court enforced the consent provision in a D&O insurance policy and held that, as a result, The Bear Stearns Companies, Inc. had no coverage under the policy for settlement amounts it agreed to pay without the insurer's prior consent. In *Vigilant Ins. Co. v. Bear Stearns Cos.*, the New York Court of Appeals held that Bear Stearns violated the consent provision in its D&O insurance policy by entering into a settlement with the SEC, in which it agreed to pay \$80 million to resolve an outstanding investigation into alleged analyst conflicts of interest, before notifying its D&O insurer or obtaining the insurer's approval.ⁿ⁶⁴ The Court of Appeals, applying New York law, granted the insurer's motion for summary judgment and held that Bear Stearns could not recover the settlement proceeds from the insurer. Importantly, the court focused on the language of the D&O insurance policy exclusively; it did not require the insurer to demonstrate that it had suffered any prejudice from Bear Stearns' failure to obtain prior consent.

[4] Common Coverage Exclusions

[a] Categories of Exclusions

As discussed above, the defined terms in D&O insurance policies frequently contain exclusions--such as the exclusion for fines and penalties--that can materially affect the scope of coverage under a policy. D&O insurance policies generally also include a list of exclusions that carve out certain acts and types of liabilities from coverage under the

policy. These exclusions, which are discussed below, generally fall into three categories:

- (1) Exclusions pertaining to the conduct of the insured that the insurer has deemed to be uninsurable or inappropriate for coverage.ⁿ⁶⁵ These exclusions constitute what one commentator has referred to as "corporate governance exclusions" because they "have their origin in principles of good corporate governance and, in particular, state statutory law regarding indemnification of directors and officers by the corporation and ... laws exculpating directors and officers from liability in certain circumstances."ⁿ⁶⁶
- (2) Exclusions pertaining to matters that should be covered under other insurance policies.ⁿ⁶⁷
- (3) The "insured versus insured" exclusion.ⁿ⁶⁸

As discussed in more detail below, some of the more common exclusions from coverage may preclude coverage for violations of the Sarbanes-Oxley Act.

[b] Conduct of the Insured

The conduct exclusions in a D&O insurance policy prohibit coverage for acts that the insurance carrier determines are uninsurable or inappropriate for coverage. Conduct exclusions typically carve out coverage for:

- **Criminal or fraudulent acts.** A typical exclusion for criminal or fraudulent acts precludes coverage for claims "brought about or contributed to by the fraudulent, dishonest or criminal acts" of the insured.ⁿ⁶⁹ As with the personal profits exclusion discussed below, much of the conduct covered by this exclusion is conduct for which state corporate law prohibits indemnification and the elimination or limitation of liability. To maximize the scope of coverage and obtain an exclusion that is written as narrowly as possible, corporations should look for two characteristics in a dishonesty exclusion. First, policy language that requires "deliberate" dishonest acts is preferable to broader language that excludes coverage for acts that are merely "dishonest" because a state-of-mind requirement can make it more difficult for an insurer to deny coverage. According to one commentator, the requirement of deliberate dishonesty "implies that the activity was decided upon after examination and reflection, and that the consequences of such deliberate action were weighed and carefully considered."ⁿ⁷⁰

Second, the language of the policy should require a "final adjudication" that establishes the occurrence of a fraudulent or criminal act or a factual record that would support a finding that such an act occurred. This is preferable to language, found in some policies, requiring a showing that a fraudulent or criminal act occurred "in fact" because it precludes an insurer from arguing for application of the exclusion absent a final judgment establishing that misconduct occurred.ⁿ⁷¹ Accordingly, the requirement of a final adjudication affords an officer or director greater protection because an insurer must await the outcome of the underlying claims against the insured before the exclusion attaches. It also means that if an underlying claim is settled without an adjudication regarding the excluded conduct, the exclusion does not apply. Language that is most favorable to the insured would specify that the final adjudication of a fraudulent or criminal act must occur in the context of the underlying claim. This type of language is designed to prevent an insurer from litigating the existence of an insured's fraudulent or criminal act in a subsequent coverage action and attempting to establish, regardless of the outcome in the underlying litigation, that the insured's misconduct precludes coverage under the policy.

The breadth of a typical exclusion for criminal or fraudulent acts could block insurance coverage for violations of several provisions of the Sarbanes-Oxley Act. For example, a finding of liability under Section 303, relating to improper influence on auditors,ⁿ⁷² would mean that an individual had the requisite intent to fraudulently influence, manipulate or mislead the company's outside auditor, which

could constitute deliberate wrongdoing. In addition, a conviction for violating Section 906 of the Sarbanes-Oxley Act,ⁿ⁷³ relating to certifications of financial reports, requires a finding that the convicted officer made his or her certification while "knowing" that the financial report did not meet the requirements of Section 906.

- **Short-swing profits.** The exclusion for short-swing profits precludes coverage for the return of short-swing profits paid in violation of Section 16(b) of the 1934 Act.ⁿ⁷⁴

- **Personal profits and illegal remuneration.** The "personal profits" exclusion precludes coverage for claims that arise where an insured gains a personal profit or advantage to which the insured was not legally entitled, and for the return of remuneration or compensation that is paid to an insured in violation of the law. Because the exclusion often applies to claims relating to self-dealing and conflicts of interest, much of the conduct that falls within the personal profits exclusion is conduct for which state corporate law prohibits indemnification and the elimination or limitation of liability under exculpatory charter provisions. The language of the exclusion should be drafted to provide that it is triggered only where there is a "final adjudication" that a director or officer has gained an improper personal profit. As discussed above in connection with the exclusion for criminal or fraudulent acts, this is preferable to the "in fact" language found in some policies because it precludes an insurer from arguing for application of the exclusion in the absence of a final judgment establishing that an insured gained an improper personal profit, and therefore affords greater protection to insureds. The personal profits exclusion could be relevant if the chief executive officer or chief financial officer must disgorge a bonus under Section 304 of the Sarbanes-Oxley Actⁿ⁷⁵ following a restatement, or if a director or officer were found liable for trading during a pension fund blackout period under Section 306 of the Sarbanes-Oxley Act.ⁿ⁷⁶

In a 2004 case involving the application of the personal profits exclusion in a D & O insurance policy, the Court of Appeals for the Fifth Circuit affirmed a lower court holding that the exclusion barred coverage for all of a company's directors and officers based on the conduct of a single individual who was found to have gained an improper personal profit.ⁿ⁷⁷ *TIG Specialty Insurance Co. v. PinkMonkey.com Inc.* involved a jury verdict against Patrick Greene, the Chairman, Chief Executive Officer and majority stockholder of PinkMonkey.com, an internet start-up company, for statutory stock fraud under Texas law in connection with the sale of the company's stock. PinkMonkey.com's D&O insurance policy contained an exclusion from coverage for any claim based on "an Insured having gained in fact any personal profit, remuneration, or advantage to which such Insured was not legally entitled."ⁿ⁷⁸ After concluding that the personal profits exclusion barred coverage for Greene,ⁿ⁷⁹ the three-judge panel of the Fifth Circuit ruled two to one that the exclusion also precluded coverage for PinkMonkey.com's other directors and officers, even though they did not obtain an improper personal profit.ⁿ⁸⁰ The court held that, under the plain language of the policy, "a claim arising out of an Insured having gained a personal profit is not limited to a claim against the Insured who profited."ⁿ⁸¹ According to the court, because the claims against PinkMonkey.com's other directors and officers were based upon Greene having gained a profit to which he was not legally entitled, the exclusion barred coverage for them as well.ⁿ⁸²

The result in the *TIG Specialty* case highlights another important attribute of a D&O insurance policy: severability. Although the policy in *TIG Specialty* apparently did not contain severability language, this language is essential where one or more directors or officers covered under a D&O insurance policy is accused of deliberate fraudulent or dishonest conduct but other officers and directors were unaware of the conduct. A "severability of exclusions" clause provides that the wrongful acts of one insured may not be imputed to other insureds, which can prevent a denial of coverage with respect to innocent insureds based on the wrongful acts of others covered by the policy. Strong severability language also is critical in preventing rescission of a policy based on misrepresentations made by some but not all of the

insureds.n83

Along the same lines of the personal profit exclusion, a number of courts have held that insurers have good grounds to deny coverage in situations where a corporation is sued either for restitution or for disgorgement of ill-gotten gains. The reason for precluding coverage in such cases is that an insurer should not have to pay when the insured wrongfully obtains assets or funds and has to return those assets or funds to their rightful owner. The availability of D&O insurance coverage for "ill-gotten gains" has arisen with increasing frequency in recent years in the context of lawsuits alleging violations of Section 11 of the 1933 Act. Section 11 applies to public offerings and other underwritings of securities and imposes strict liability on companies for material misrepresentations and omissions in offering documents. Section 11 claims typically involve a public securities offering in which the company issuing the securities is accused of making false statements in the registration statement, thus obtaining for itself the proceeds of the offering to the detriment of investors. For instance, in *Level 3 Communications, Inc. v. Federal Insurance Co.*, the U.S. Court of Appeals for the Seventh Circuit held that a claim for securities fraud did not properly constitute a "loss" under the terms of a D&O insurance policy because the plaintiffs were essentially seeking restitution of ill-gotten gains.n84 The underlying claim for securities fraud against Level 3 was that former stockholders of Level 3's predecessor had sold their shares back to the company for less than they were worth because Level 3's predecessor had withheld material information from the former stockholders.n85 The Seventh Circuit agreed with the insurer's characterization of the lawsuit that "[i]t's as if ... Level 3 had stolen cash from the [former stockholders] and had been forced to return it and were now asking the insurance company to pick up the tab."n86 The court distinguished a claim for restitution from a securities fraud claim where the defendant did not directly benefit from the fraud.n87

In the wake of the Seventh Circuit decision in *Level 3*, an Indiana state court issued a decision that has become a source of controversy on the issue of coverage for Section 11 claims under the 1933 Act. In *Conseco, Inc. v. National Union Fire Insurance Co.*,n88 the state court held that under Indiana law, public policy would bar coverage for a Section 11 claim. The *Conseco* analysis hinged on the definition of "loss" in the company's D&O insurance policies, which provided that loss shall not include "matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed."n89 Thus, if a Section 11 claim were to be deemed uninsurable under some state's law, the policy definition of loss would exclude the claim from coverage. In *Conseco*, the court viewed a Section 11 claim as inherently restitutionary in nature--if successful, the plaintiff essentially forces the company to give the public offering proceeds back. As such, coverage for the claim ran afoul of Indiana public policy, which barred insurance for payments that are restitutionary in nature.

In two subsequent cases after *Conseco*, courts split on the issue of whether the traditional definition of "loss" precludes coverage for Section 11 claims. In March 2007, the Middle District of Florida held that a settlement paid by the insured in a disgorgement case under Section 11 was not a defined "loss" under the D&O policy, and that two insurers who denied coverage were within their rights in doing so.n90 The insurers denied coverage after the insured corporation, CNL Hotels & Resorts, settled two class action suits related to improper accounting included in a combined proxy statement/prospectus filed using a Form S-4 under which stockholder approval was obtained for a material acquisition. The class actions sought to nullify the stockholder approval and to obtain an injunction to prevent the consummation of a related underwritten offering later postponed by CNL. In the settlement, CNL agreed to establish a \$35 million fund that would be used to pay the Section 11 claims, but it did not admit wrongdoing in connection with the claims in the class action.n91 The insurers, however, took the position that the settlement fund was a type of disgorgement related to the Section 11 violations and not an actual "loss," and on that basis, the insurers were entitled to deny coverage. Applying New York law, the court agreed, finding that the payout in and of itself was not an insurable loss because an insured "may not insure itself against the risk of having to return money that it has obtained improperly."n92 The Eleventh Circuit affirmed the decision of the lower court in August 2008.n93

In contrast, in a decision in December 2007, a state court in North Carolina concluded that certain Section 11 claims involved in the WorldCom litigation were covered under a D&O insurance policy.n94 *Bank of America Corp. v. SR International Business Insurance* involved Section 11 claims made against Bank of America as an underwriter of two

public bond offerings. The court distinguished the *Level 3* and *CNL* cases on the basis that, in those cases, the plaintiffs sought recovery from the issuers of the securities, who had allegedly received "ill-gotten gains" as a result of their own officers' misconduct.ⁿ⁹⁵ In contrast, the court observed that Bank of America was not the issuer of the bonds that gave rise to the lawsuit and did not receive the proceeds of the bond offering. Therefore, the court concluded, the damages sought in the lawsuit were not restitutionary in nature.ⁿ⁹⁶

The results in *Conseco*, *CNL* and other similar cases have disrupted settled expectations in the D&O insurance industry, which traditionally had understood that D&O insurance policies would, and should, cover Section 11 claims. In this regard, it is important to note that Section 11 imposes strict liability, and that companies often make the judgment to settle claims as an alternative to protracted expensive litigation. Accordingly, a company that agrees to settle a Section 11 claim has not necessarily engaged in conduct that resulted in the receipt of "ill-gotten gains." In this respect, Section 11 claims are precisely the types of claims for which companies buy insurance. In response to concerns about the results in these cases, several major D&O insurers now offer a "public offering endorsement" to their policies in which they agree not to assert that losses resulting from the settlement of Section 11 claims are uninsurable under their policies. At least one large insurer offers an expanded version of this endorsement that applies to judgments as well as settlements.

[c] Matters Covered Under Other Insurance Policies

A second category of exclusions in a typical D&O insurance policy covers matters that should be insured under other types of policies. These exclusions generally address:

- **"Bodily injury."** Claims for bodily injury, sickness, disease, or death of any person, and claims for damage to, or destruction or loss of any tangible property are typically excluded from coverage under a D&O insurance policy because they are covered by a comprehensive or commercial general liability insurance policy.
- **Violations of the Employee Retirement Income Security Act of 1974.** Claims against fiduciaries for violations of the Employee Retirement Income Security Act of 1974 are typically excluded from coverage under a D&O insurance policy because they are often covered by a fiduciary liability policy.
- **Environmental liabilities.** Claims arising out of pollution conditions are typically excluded from coverage under a D&O insurance policy under the so-called pollution exclusion because they are often covered under a comprehensive or commercial general liability policy.ⁿ⁹⁷ Alternatively, they may be covered by a separate pollution liability or environmental impairment policy.
- **Earlier D&O policies.** Claims to which an earlier D&O insurance policy was applicable are generally excluded from coverage.
- **Pending and prior litigation.** Claims arising out of litigation that was pending as of, or completed prior to, the inception date of the D&O insurance policy are generally excluded from coverage, although the exclusion is not strictly limited to pending and prior "litigation." Typically, it covers any claims under the policy arising out of litigation, claims, demands, arbitrations, decrees or judgments occurring prior to or pending as of the inception date of the policy that were known to the corporation or its directors and officers. Claims arising out of future litigation that is based on or derived from substantially the same facts that gave rise to the earlier litigation are generally also excluded.
- **Claims insured under other policies.** D&O insurance policies also typically contain an exclusion for any claims that are insured against by any other policies (except to the extent those policies are specifically written as excess insurance over the coverage provided by the D&O insurance policy). The effect of this exclusion is to make the D&O policy excess over other insurance policies that may apply to

a given claim.

[d] Insured versus Insured Exclusion

Another exclusion commonly seen in D&O insurance policies is the "insured versus insured" exclusion. Consistent with the underwriting philosophy behind a D&O insurance policy, which is to provide coverage brought for claims brought by third parties, the "insured versus insured" exclusion generally precludes coverage for losses arising out of claims against a director or officer by another director or officer or by the corporation. The purpose of the exclusion is to prevent corporations from cashing in on their D&O policies by suing officers and directors. In addition, where there are insureds on both sides of a claim, there is the potential for collusion and a reduced incentive to cooperate with the insurer and mount a vigorous defense. In most policies, the exclusion contains an important carve-out for stockholder derivative suits, which, in the absence of appropriate qualifying language, would fall within the scope of the exclusion because they are brought in the name of the corporation.

When a policy uses an expanded definition of "insured," a number of questions may arise as to the applicability of the insured versus insured exclusion. One of these questions is whether an insurer can use the insured versus insured exclusion to deny coverage if former officers and directors file a lawsuit against the corporation. In at least one court's 2006 opinion, the answer to that question was "no." In *MegAvail, Inc. v. Illinois Union Ins. Co.*,⁹⁸ two former officers and directors of a corporation joined forces with four other stockholders to file a derivative action against certain current officers and directors alleging breach of fiduciary duty and misappropriation of corporate opportunities.⁹⁹ The insurer denied coverage, taking the position that the suit fell under the insured versus insured exclusion, which defined former officers and directors as "insureds."¹⁰⁰ The Court disagreed, however, holding that the action was not collusive and that the former officers and directors had acted independently. Furthermore, the allegations in the suit fell within those covered under the policy and thus the insurer was bound to provide coverage.¹⁰¹ To address the subject of suits by former officers and directors, it is fairly common for insured versus exclusions to contain an exception that preserves coverage for suits brought by former officers and directors of a corporation who have not served in that capacity for a specified period of time (such as three to four years) before a claim is filed.

Another area that implicates the insured versus insured exclusion is whistleblower claims, which have become more of a focus post Sarbanes-Oxley. In circumstances where whistleblowers are officers, coverage for whistleblowers' claims would otherwise be precluded under a traditional insured versus insured exclusion. Insurers are addressing this by providing exceptions to the exclusion for claims by one insured (such as an officer) against another insured (such as the corporation or another officer or director) to provide coverage for whistleblower claims.

The insured versus insured exclusion also is relevant in the bankruptcy context, where suits are often brought by a corporate debtor against the bankrupt corporation's directors and officers. Insurers have sought to exclude coverage in such suits by arguing that the bankruptcy trustee, who brings the suits, has simply stepped into the shoes of the corporation. Courts have reached differing results on this issue.¹⁰² A number of courts have rejected this argument on the grounds that a bankruptcy trustee is an entity separate and distinct from the corporate debtor and that the purpose of the exclusion--which is to prevent collusive lawsuits by corporate insiders--does not apply in the context of claims brought by a trustee against a debtor corporation's directors and officers because the trustee is asserting those claims on behalf of creditors. Accordingly, unlike the debtor corporation, the trustee is truly adverse to the debtor corporation's directors and officers and there is no danger of collusion.¹⁰³

On the other hand, some courts have concluded that the insured versus insured exclusion bars coverage for claims brought by a bankruptcy trustee, reasoning that there is no legal distinction between the trustee and the debtor corporation and that, as a result, any claims brought by the trustee are brought on behalf of the company.¹⁰⁴

In recent years, it has become standard for the insured versus insured exclusion in a D&O insurance policy to carve out claims brought by a bankruptcy trustee, receiver, debtor-in-possession or equivalent, so that coverage for these claims is

available. Regardless of the financial health of a corporation, at the time it obtains a D&O insurance policy, it is critical that the insured versus insured exclusion in the policy contain a well-drafted bankruptcy carve-out.

[5] Severability and Rescission

When a D&O insurance policy is issued or renewed, it is typically preceded by an underwriting process in which the company submits information to the insurer for the purposes of assessing the risk of insuring the company. This information includes details about the company's financial and operational performance. In most cases, a written application is required. The D&O insurance policy typically contains a clause in which the insurer incorporates all of the company's public statements into the policy application, including statements that the company has made in its periodic filings with the SEC, going back for a specified period, such as 12 months. The policy also will contain a provision that, in one form or another, states that the policy is being issued or renewed in reliance upon the information transmitted or incorporated by reference into the application, and that if there are any materially false statements or omissions in the application, the policy can be voided. In securities cases, the truth of the company's public statements is typically at issue, particularly in cases involving restatements of financial statements, where plaintiffs often argue that a restatement, by definition, rendered the company's prior SEC filings false. In these types of cases, insurers have sought to rescind policies on the grounds that the policies were induced by misstatements of material fact in the application for coverage. If successful, rescission renders a policy void *ab initio*, and it is as if coverage never existed.

Insurers have become increasingly aggressive in their efforts at rescission, as evidenced by the insurers for Enron Corp., WorldCom, Inc., Tyco International Ltd, Adelphia Communications Corporation, HealthSouth Corporation, and other companies that have faced financial scandals. Where an insurer attempts to rescind a D&O insurance policy, the existence of a "severability of the application" clause in the policy can be critical to preserving coverage.ⁿ¹⁰⁵ In the absence of such a clause, innocent directors and officers may lose coverage, and a company may be forced to use corporate funds (rather than relying on insurance) to pay defense and other costs associated with legal proceedings, as was the case with Homestore, Inc. As the protracted legal proceeding over former Homestore officer Peter Tafeen's right to advancement of expenses was drawing to a close,ⁿ¹⁰⁶ two courts issued rulings permitting rescission of Homestore's D&O insurance policies based on misrepresentations about Homestore's financial condition contained in the company's applications for D&O insurance coverage.ⁿ¹⁰⁷ The policy language provided that the policies would be void in their entirety if misrepresentations were known by "one or more of the individuals who signed" the applications for coverage. Based on this language, the courts permitted rescission of the policies as to all of Homestore's directors and officers as a result of misrepresentations known to Homestore's CFO, who signed the applications. The Ninth Circuit also rejected the argument that the public policy of California (whose law governed the policies) prevented rescission as to "innocent" directors and officers who had no knowledge of the misrepresentations because of the "unambiguous language" of the policy coupled with California's Insurance Code, which mandates that the right to rescind applies to all insureds unless the policy provides otherwise.ⁿ¹⁰⁸

A "severability of the application" clause, as its name suggests, creates a legal and contractual basis to distinguish between various individuals' knowledge at the time a D&O insurance policy was issued or renewed, and to limit the categories of people whose knowledge may allow the insurer to void the policy due to an allegedly misleading application. The effect of such a clause is that an insurer cannot rescind coverage for one insured based on misrepresentations made by other insureds in the application for coverage.

Rescission is governed by state common law, and sometimes by statute, and the elements required to support a claim for rescission vary from state to state.ⁿ¹⁰⁹ Most states permit insurers to rescind a policy if the insured made a material misrepresentation and the insurer relied on the misrepresentation in issuing the policy.ⁿ¹¹⁰ Only a minority of states imposes the additional requirement that the insured have had knowledge that a misrepresentation was false or have intended to deceive the insurer.ⁿ¹¹¹ Accordingly, under the laws of most states, it could be argued that a severability provision barring imputation of knowledge is irrelevant, because knowledge of the insured is not an element of a rescission claim, and therefore, knowledge (and imputation of knowledge) are irrelevant. However, courts increasingly

are treating state law requirements as minimum protections that must be afforded to insureds, while allowing the negotiation of more favorable protections--in the form of severability language--than that provided under applicable state law.¹¹² Accordingly, courts are enforcing severability clauses, and denying insurers' claims for rescission, even where knowledge of a misrepresentation or an intent to deceive is not required under state law in order for an insurer to rescind a policy.¹¹³

Severability clauses can vary greatly from one D&O insurance policy to the next, and may take the form of "partial" or "full" severability. Severability language that does not allow an insurer to impute the misrepresentations of one insured to other insureds generally is thought to provide the greatest protection against rescission and often is referred to as "full" severability.¹¹⁴ A typical full severability clause states that the application for insurance coverage:¹¹⁵

will be construed as a separate application for coverage by each individual insured and that the knowledge of one individual insured will not be imputed to any other individual insured for purposes of determining if coverage is available.

If the policy includes entity coverage, the full severability language may also state that only the knowledge of certain executive officers is imputed to the company for purposes of determining coverage.

Courts generally have interpreted full severability language as limiting an insurer's right to rescind coverage to those individuals who made knowing misrepresentations in the application for coverage or otherwise had knowledge of underlying fraud. For example, in a rescission action brought by insurers of HealthSouth Corporation, the court concluded that a full severability clause in HealthSouth's D&O insurance policies required proof of knowing misrepresentations personally made by each insured for which the insurers sought to void coverage.¹¹⁶ The insurers claimed that HealthSouth had used materially false and misleading financial information to procure insurance coverage, and that the policies were therefore void *ab initio*. The court, applying Alabama law, held that the insurers did not have the right to rescind the policies.¹¹⁷ The court stated that even though the applicable state statute permitted insurers to void coverage on account of innocent but otherwise material misrepresentations, the "full" severability language modified the statutory protection and "unambiguously provide[d] that the rights of each insured as to coverage will be separately determined."¹¹⁸

In contrast to full severability language, more limited "partial" severability language generally imputes the knowledge of the individuals who signed the application for coverage to all insureds. A typical partial severability clause provides that:¹¹⁹

no knowledge or information possessed by any individual insured will be imputed to any other individual insured except for material facts or information known to the persons who signed the application.

As the language of this clause illustrates, partial severability language does not protect even innocent insureds in circumstances where an individual signing the application for insurance coverage has knowledge of wrongdoing. The case of *Cutter & Buck, Inc. v. Genesis Insurance Company* illustrates circumstances in which innocent directors and officers lost their coverage entirely due to the limitations of partial severability language in the company's D&O policy.¹²⁰ In *Cutter & Buck*, the court, applying Washington law, permitted complete rescission of Cutter & Buck's D&O insurance policy as to all of the company's insured directors and officers. The policy contained a poorly drafted partial severability clause that precluded the imputation of knowledge possessed by one insured to other insureds except in the case of "material information known to the person or persons who signed the Application."¹²¹ The company's CFO knew that the financial statements, which were part of the application for coverage, contained false information. Because the CFO signed the application, his knowledge was imputed to all the other insureds, and the court held that the insurer had the right to rescind coverage.¹²² As a result, the company's remaining directors and officers were left entirely without coverage.

One development in the rescission area that is favorable to directors and officers is reflected in several cases limiting an insurer's unilateral right to rescind D&O insurance policies. Traditionally, insurers have assumed, based on contract law, that they have a unilateral right to rescind a policy by returning premium payments to an insured. However, in cases involving Tyco International Ltd. and Adelphia Communications Corporation, two courts have held that, until a rescission claim is litigated in favor of an insurer and there is a judicial declaration that a policy is void *ab initio*, coverage remains in effect.ⁿ¹²³ In *Tyco*, the company's former Chairman and CEO, L. Dennis Kozlowski, was a defendant in more than 30 civil lawsuits and criminal proceedings alleging misconduct in his capacity as a Tyco officer. When Kozlowski notified Tyco's insurer of the lawsuits and demanded that the insurer either provide him with a defense or pay his defense costs, the insurer unilaterally rescinded the policies and returned Tyco's premiums on the ground that Kozlowski had misrepresented material information about Tyco's finances and other matters in the applications for insurance. The insurer sought a declaration confirming that the policies were rescinded and void *ab initio*. Kozlowski sought a declaration that the insurer had a duty to defend him or pay his defense costs in several of the lawsuits. In the absence of significant New York case law on the subject, the Supreme Court of New York looked to rulings from other jurisdictions holding that "an insurer's present duty to defend under a liability policy is unaffected by an unproven claim for rescission."ⁿ¹²⁴ Based on this, the court held that until the insurer's rescission claims were litigated in its favor and the policies were declared void *ab initio*, the policies remained in effect and bound the parties.ⁿ¹²⁵ The court went on to conclude, however, that if the insurer ultimately prevailed in its rescission action and the policies were declared void, the insurer might recover the defense costs it had provided Kozlowski.ⁿ¹²⁶

Similarly, in a proceeding involving former directors and officers of Adelphia Communications Corporation, the U.S. District Court for the Eastern District of Pennsylvania held that, in the absence of rescission, Adelphia's insurers were obligated to advance defense costs.ⁿ¹²⁷ In *Associated Electric & Gas Insurance Services, Ltd. v. Rigas*, Adelphia's insurers argued that they had no obligation to advance defense costs to five former directors and officers of Adelphia because the insurers had rescinded the policies on the ground that the policies had been procured by fraud. Adelphia's primary D&O insurance policy, which was the focus of the case, was silent on the issue of rescission. The insureds argued that the insurers had no unilateral right to rescind the policy without an adjudication that rescission was proper because a unilateral right of rescission would result in an unconscionable contract. Accordingly, the insureds argued, until an adjudication occurred, the insurers were obligated to advance the insureds' defense costs.

The procedural posture in the *Adelphia* case was somewhat unusual because the automatic stay imposed under *Section 362 of the U.S. Bankruptcy Code*ⁿ¹²⁸ in Adelphia's bankruptcy proceedings precluded the Pennsylvania district court from making a determination on the issue of rescission.ⁿ¹²⁹ In addition, the insurers had not completed the unilateral rescission because, in their view, the automatic stay prevented them from returning the insurance premiums.ⁿ¹³⁰ However, the court nevertheless considered the issue of rescission, and, citing the *Tyco* decision, concluded that "because a contract is in effect until the issue of rescission is adjudicated, an insurer is bound by the obligations in that contract to advance defense costs until the contract is found to be rescinded."ⁿ¹³¹ The court went on to consider whether the language of the policy required the insurers to advance defense costs, and concluded that it did.ⁿ¹³² In reaching this conclusion, the court noted that it was influenced by public policy considerations, including the presumption of innocence to which directors and officers are entitled.ⁿ¹³³

The subject of severability also arises in the context of the conduct exclusions in D&O insurance policies. These exclusions typically preclude coverage for criminal or fraudulent acts, as well as short-swing profits paid in violation of Section 16(b) of the 1934 Act, and personal profits or remuneration to which an insured was not legally entitled.ⁿ¹³⁴ A "severability of the exclusions" clause typically states that "[t]he Wrongful Act of an Insured shall not be imputed to any other Insured for the purpose of determining the applicability of" the conduct exclusions in the policy. Such a clause is intended to prevent an insurer from denying coverage to innocent insureds based on misconduct committed by another insured.

Securing appropriate severability language to safeguard against both denials of coverage and rescission is critical. It is

of greatest importance with respect to a company's primary policy, because this policy provides the first line of defense to a company's directors and officers. However, severability language also is important in excess policies, because these policies will provide coverage if the primary policy is exhausted or unavailable.ⁿ¹³⁵ An excess policy may not always contain the same severability protections as the primary policy, and it is important to examine the language of the excess policy on this point.ⁿ¹³⁶ A Side A excess policy (that is, a policy that covers only the company's directors and officers) that specifically provides that it is nonrescindable also can protect against rescission.ⁿ¹³⁷

A 2009 case involving D&O insurance coverage issued to Refco Inc. illustrates the distinction between the two types of severability language discussed above--"severability of the application" and "severability of the exclusions" clauses--as well the interplay between the severability language in primary and excess D&O insurance policies. The policies at issue in *XL Specialty Insurance Co. v. John D. Agoglia* ⁿ¹³⁸ were issued to Refco in connection with its 2005 initial public offering. Two months after the offering, Refco announced that it had been carrying an undisclosed \$430 million receivable from an entity controlled by its CEO. The receivable had been hidden from Refco's auditors for years through fraudulent loan transactions. Following the announcement, Refco's stock plummeted, and the company later filed for bankruptcy. In the wake of these events, the CEO pled guilty to criminal charges relating to his participation in the fraudulent scheme to conceal the receivable, and the company's directors and officers became the targets of extensive litigation, for which they sought coverage under Refco's D&O insurance policies. Like many other public companies, Refco had a D&O insurance program that consisted of a primary policy and several excess policies. In *XL Specialty*, three of Refco's excess insurers moved for summary judgment seeking a declaration that they were not obligated to provide coverage to Refco's directors and officers under "prior knowledge" exclusions in the D&O insurance policies on the grounds that the CEO had knowledge of the undisclosed receivable at the time the policies were issued. A prior knowledge exclusion typically bars coverage for claims arising out of acts, errors or omissions committed prior to the inception of the insurance policy if the insured knew or should have known such an act, error or omission could result in a claim. The court granted summary judgment to the third and fourth excess insurers and denied summary judgment to the fifth level excess insurer.

The third and fourth excess policies issued to Refco were "follow-form" policies, meaning that they provided coverage on the same terms and conditions as the primary policy, except to the extent that they contained limitations or restrictions beyond those in the primary policy. The primary policy contained a "severability of the exclusions" clause stating that:ⁿ¹³⁹

For purposes of determining the application of the above EXCLUSIONS, no Wrongful Act of any Insured Person will be imputed to any other Insured Person who did not have actual knowledge of, or directly participate in the commission of, such Wrongful Act.

The court concluded that this provision did not apply to the excess policies because it applied only to the "above" exclusions--that is, the exclusions in the primary policy.ⁿ¹⁴⁰ The primary policy also contained a provision titled "Full Severability," which stated in part that:ⁿ¹⁴¹

No knowledge or information possessed by any Insured will be imputed to any other Insured. If any of the particulars or statements in the Application is untrue, this Policy will be void with respect to any Insured who knew of such untruth.

The insureds argued that this provision was not simply a "severability of the application clause," but rather, that it operated more broadly as a general non-imputation clause to prevent denials of coverage to innocent insureds.ⁿ¹⁴² The third and fourth excess policies themselves also contained a prior knowledge exclusion stating that the insurer would not be liable for losses in connection with a claim arising out of facts or circumstances as to which *any insured* had knowledge or information.ⁿ¹⁴³ The court found that it was irrelevant whether the "Full Severability" provision in the primary policy applied more broadly because it was superseded by the prior knowledge exclusions in the third and fourth excess policies. Therefore, the court held that the prior knowledge exclusions precluded coverage for all insureds

because of the CEO's prior knowledge of the undisclosed receivable.

The fifth excess policy issued to Refco was not a "follow-form" policy and included both a severability clause and a prior knowledge exclusion. The severability clause looked like a traditional "severability of the application clause," but stated, without limiting the statement to the insurance application, that:¹⁴⁴

No knowledge or information possessed by any Insured Person will be imputed to any other Insured Person for the purposes of determining the availability of cover-age with respect to Claims made against any other Insured Person.

The prior knowledge exclusion included in the fifth excess policy stated that no coverage would be available under the policy for claims arising from any fact, circumstance or situation as to which *any insured* had knowledge.¹⁴⁵ The court held that because both the severability clause and the prior knowledge exclusion were in the same policy, the prior knowledge exclusion did not automatically supersede the severability clause and the insurer had not met its burden of showing that the severability clause was limited to statements contained in the insurance application. As a result, summary judgment was not appropriate because if the severability clause were found to operate more broadly, the insurer would not be able to deny coverage to all insureds on the basis of the CEO's prior knowledge of the undisclosed receivable.¹⁴⁶

[6] Entity Coverage

Entity coverage provides insurance to a corporation for claims that are brought directly against it. In this regard, it represents an expansion of traditional D&O insurance, which historically focused on protecting the personal assets of a corporation's directors and officers, rather than the corporation itself. Entity coverage emerged in the mid-1990s as a solution to the problem of allocation in securities lawsuits. Prior to the existence of entity coverage, it was common for insurers and corporations to negotiate a division between the losses that the D&O policy would cover and the losses that would be allocated to the corporation--which was not insured under the policy--for its own liabilities. This led to gaps in coverage and disputes about allocation. Entity coverage was intended to eliminate these difficulties and to align the interests of insurers, and corporations and their directors and officers, in defending litigation. Although entity coverage did eliminate the issues raised by allocation, it also had the negative effect of diluting the coverage afforded to directors and officers. Where a D&O insurance policy has shared liability limits applicable to both the company and its directors and officers, directors and officers face the risk that policy limits will be eroded or exhausted by payment of the company's claims.

In the wake of Enron Corp.'s collapse and the exposure of major accounting and financial irregularities at other large U.S. public companies, one issue that has arisen with increasing frequency is the effect of entity coverage on a D&O insurance policy once a corporation files for bankruptcy. D&O insurance takes on an increased importance in bankruptcy because a corporate debtor may be unable or unwilling to pay judgments, settlements and costs of defense incurred by the debtor's directors and officers. Where a corporation is itself an insured under a D&O policy because of the existence of entity coverage, there is a possibility that the proceeds of the entire policy may be deemed an asset of the bankruptcy estate.¹⁴⁷ This, in turn, means that policy proceeds that could otherwise be paid to directors and officers--who are also insureds under the policy--may not be available.¹⁴⁸

For example, in a 2005 proceeding involving a primary D&O insurance policy, a bankruptcy court concluded that, due to the presence of entity coverage, the debtor corporation had a limited right to a portion of the policy proceeds. In *National Century Financial Corporation v. Gulf Insurance Company, Inc.*,¹⁴⁹ National Century, the debtor corporation, argued that the court should allocate the proceeds of the policy proportionally according to the amount of the losses, which would have resulted in National Century taking almost all of the proceeds. National Century's directors and officers argued that the debtor's claims should be subordinated. The policy had no "priority of payments" provision or other language addressing allocation. After noting that, without subordination, the debtor would take "the

mammoth portion" of the policy proceeds and that this would not serve the underlying reason for the issuance of D&O insurance policies, the court partially subordinated the debtor's claims against the Side B and entity coverage under the policy, awarding the directors and officers 70% of the proceeds and the debtor corporation the remaining 30%. The court did not explain how it arrived at this allocation, except to state that this was a "proper balance." In allocating the 70% of the policy proceeds among the seven directors and officers, the court noted that the weight of authority supported a pro rata allocation (which would give each individual the same percentage of his or her defense costs), but concluded that a per capita approach would be more equitable. Given the limited funds available under the policy, the fact that the expenses incurred would far exceed the available proceeds, and the wide range of expenses incurred by the directors and officers, the court concluded that equity dictated giving each individual an equal amount. The end result of the court's decision was that, of a \$5 million policy, the debtor corporation received \$1.5 million, while each individual director and officer received \$500,000.

Many courts distinguish between an insurance policy and its proceeds when deciding whether the policy is estate property. When considering other types of insurance policies, such as a general liability or fire protection policy, the general result is that if a policy is property of the estate, then its proceeds also belong to the estate.¹⁵⁰ Yet courts have recognized that this general rule is inappropriate for D&O insurance policies, because D&O insurance policies differ fundamentally from other types of liability insurance. First, the company often is not the direct beneficiary.¹⁵¹ In most cases, the debtor corporation has purchased the policy for the benefit of its directors and officers, not for the benefit or protection of the corporation itself.¹⁵² Also, the proceeds from Side A and Side B coverage do not ultimately inure to the benefit of the company, but to its officers and directors.¹⁵³ As a result of the structural differences between D&O and general liability insurance policies, courts have created a distinction between ownership of the D&O insurance policy and ownership of its proceeds. Numerous courts have held that D&O policies themselves--in contrast to their proceeds--are property of the bankruptcy estate, especially policies that combine coverage for individual directors and officers with Side B (indemnification) and entity coverage.¹⁵⁴ Entity coverage, by contrast, is written for the protection and benefit of the corporation, not its directors and officers. Courts have reached differing results on the issue of whether policy proceeds are assets of the estate,¹⁵⁵ and a number of courts have concluded that this issue must be examined based on the facts of the particular case.¹⁵⁶ Courts that have conducted a fact-specific analysis have generally weighed the expected needs of directors and officers to access insurance policy proceeds to fund their defense costs against the interests of the corporate debtor, which may need the entity coverage for its own liabilities, or may seek reimbursement under the policy for indemnification to its directors and officers. A proceeding involving Adelphia Communications Corporation involved requests by certain directors and former employees of the company who sought relief from the automatic stay under *Section 362 of the U.S. Bankruptcy Code*¹⁵⁷ to make claims against the company's D&O policy insurers for costs of defense in a variety of civil lawsuits. One of the corporate debtors was a former Adelphia subsidiary that had insurance under policies purchased by Adelphia before the subsidiary was spun off. Although there was no litigation pending against the subsidiary's directors and officers, the subsidiary had been unable to obtain insurance from other carriers and sought to rely on those policies on a going-forward basis. Because the policies were subject to an aggregate limit, any sums paid out if the stay were lifted would reduce the amounts available under the policies.

The bankruptcy court concluded that the policy proceeds were property of the estate and that a motion for relief from the automatic stay was necessary to access those proceeds.¹⁵⁸ In reaching this conclusion, the bankruptcy court accorded weight to the importance of D&O insurance policies in encouraging corporate officials to serve and expressed concern that allowing insureds to lay claim to policy proceeds could hamper a corporation's ability to reorganize following bankruptcy by compromising its ability to attract qualified directors and officers:¹⁵⁹

by reason of the need to secure independent directors and officers who are willing to serve, and their legitimate desire to have D&O policy protection when continuing to serve, simply *having* a D&O policy is an important need of any company wishing to reorganize ... and ... the unfettered resort to policy proceeds by some insureds under the policies could result, as a practical matter, in the total depletion of the policies, with the result that they are no longer available to give directors and officers the comfort

they need to serve or continue to serve.

Moreover, because of the existence of entity coverage, the bankruptcy court capped the amount of insurance that the directors and former employees could seek from Adelphia's insurers, giving them permission to seek up to \$300,000 each in defense costs.¹⁶⁰

On appeal, the U.S. District Court for the Southern District of New York reversed, holding that the policy proceeds were not part of the bankruptcy estate.¹⁶¹ The court reasoned that Adelphia did not yet have a property interest in the proceeds because: (1) there was no indication that any of the debtor companies had made any payments for which they would be entitled to indemnification coverage, or that any such payments were contemplated; and (2) none of the debtors had made or committed themselves to payments using their entity coverage.¹⁶² According to the court, claiming that the debtors had a property interest in the proceeds would be akin to car owners with collision coverage claiming that they had a right to the proceeds of their insurance policies because of the possibility that an accident could occur or a living person with a death benefit policy claiming that the person's beneficiaries had a property interest in the policy proceeds even though the person remained alive.¹⁶³ As a result, the court concluded that recognizing that Adelphia had a property interest in the proceeds "makes no sense at this juncture."¹⁶⁴

Like Adelphia, Enron Corp. had entity coverage. The bankruptcy court in *In re Enron Corp.* lifted the automatic stay to permit certain present and former directors and officers of the company to access the proceeds of a D&O policy in order to pay their defense costs.¹⁶⁵ The policy in question, however, also had a "priority of payments" endorsement, which provided that both the entity coverage and the Side B coverage (under which Enron Corp. could seek reimbursement for amounts paid as indemnification) were subordinated to the rights of the insured directors and officers under the policy.¹⁶⁶ "Priority of payments" provisions have been used by some insurance carriers to address problems caused by the presence of entity coverage. Their purpose is to ensure that proceeds are paid first to directors and officers, even in the event of the corporation's insolvency. Another possible solution, offered by some insurers, is an endorsement containing a pre-petition waiver of the automatic stay. This type of endorsement typically states that, in the event of the insured corporation's bankruptcy, the corporation and the officers and directors insured under the D&O insurance policy: (1) waive and release the automatic stay to the extent it may apply to the proceeds of the policy; and (2) agree not to oppose or object to any efforts by the insurer or the insureds to obtain relief from the stay. The extent to which such a waiver would be enforceable, however, is unclear.¹⁶⁷ A third alternative to addressing the presence of entity coverage is to obtain additional coverage that is not shared with the corporation, which companies increasingly are doing.¹⁶⁸

Although entity coverage was once widespread among public companies, insurers have been moving away from providing it due to cost and uncertainty about the treatment of policy proceeds in the event of bankruptcy.¹⁶⁹ The use of an allocation clause in a D&O insurance policy can eliminate the uncertainty that exists in the bankruptcy context where a corporation has entity coverage. Unlike entity coverage, an allocation clause does not insure the corporation against claims brought against the corporation itself. Instead, such a clause guarantees that a D&O insurance policy will cover an amount of any liability imposed against the corporation's officers and directors. An allocation clause may provide for a pre-set percentage that the insurer and the corporation agree to pay in suits (such as those involving securities claims) where the corporation is sued along with its officers and directors. Alternatively, the policy language may specify that the parties will use their "best efforts" or "good faith" to agree upon an allocation, or that allocation will be made based on the relative legal exposure of the insureds.¹⁷⁰ A D&O insurance policy may also provide for the allocation of defense costs. Absent policy language addressing allocation, expenses of defense that are reasonably related to a covered claim generally can be allocated wholly to the covered claim and therefore would be covered under a policy.¹⁷¹

One case illustrating the difficulties involved in allocation is the Fourth Circuit's 2006 decision in *Perdue Farms, Inc. v. Travelers Casualty & Surety Company of America*.¹⁷² This case involved class action claims under the Fair Labor Standards Act, ERISA and wage and hour laws. The corporation's D&O insurance policy provided coverage for the

ERISA claims but not the wage and hour claims. The insured settled all claims for a total of \$10 million; however, there was no allocation of the \$10 million settlement between covered claims and uncovered claims. When the insured sought coverage from Travelers for the settlement (with a minor deduction for the wage and hour claims), Travelers denied to provide it, claiming that it had no duty to provide coverage for any portion of the settlement except what was strictly related to the ERISA claims.¹⁷³

The trial court had found in the insured's favor on the basis that the wage and hour claims were "reasonably related" to the ERISA claims and therefore covered under the policy. The Fourth Circuit reversed, holding that use of the "reasonably related" test could result in insurers footing the bill for any number of claims and settlements that were never contemplated by the policy or the parties.¹⁷⁴ The Fourth Circuit remanded the case for proceedings intended to identify exactly how much of the settlement was attributable to the ERISA claims and how much to all other claims, from which an appropriate percentage could be applied against the \$10 million to determine Traveler's coverage obligation for ERISA claims.¹⁷⁵

[7] Supplemental Coverage

An increased risk of litigation, the prospect of multi-million dollar judgments in securities class action and derivative lawsuits, and the magnitude of defense costs all have given rise to increasing concern among companies about whether the amount of their D&O insurance coverage will be adequate to protect their officers and directors, especially outside directors. Meanwhile, the prevalence of entity coverage has raised questions about the continued availability of coverage for directors and officers in the bankruptcy context.¹⁷⁶ At the same time, financial restatements and corporate scandals have heightened awareness of the risk that insurers may seek to deny coverage or rescind coverage altogether. The Sarbanes-Oxley Act has created additional responsibilities and the possibility of new liabilities for corporate officials. As a result, directors are likely to view the availability of comprehensive D&O insurance as an important factor in deciding whether to join a board or remain on a board.¹⁷⁷

To avoid the potential for dilution that exists where the company also is an insured under a D&O insurance policy, and to avoid ambiguity about directors' and officers' rights to coverage in the event of bankruptcy, corporations increasingly are purchasing separate "Side A" coverage to supplement their primary policies, which typically consist of Side A and "Side B" coverage, and sometimes entity coverage.¹⁷⁸ Other factors that have contributed to an increase in the purchase of additional Side A coverage include the following: recent, high-profile bankruptcies and settlements involving directors making personal payments¹⁷⁹; concerns that indemnifiable claims will exhaust policy limits; fear of D&O policy rescission; and perceived economies in restricting the purchase of higher limits to Side A insurance only.¹⁸⁰

Side A coverage is available either on a standalone basis that provides coverage from the first dollar up alongside a company's primary policy, or as excess coverage. Most supplemental Side A coverage takes the form of a so-called "Side A tower" that sits as excess above the standard Side A, Side B and entity coverage. Excess policies generally are "follow-form" of a primary policy--that is, they provide coverage on the same terms as the primary policy, except to the extent that any provisions in the "follow-form" policy are more restrictive than those in the primary policy. However, this is not always the case, and excess policies do not uniformly adopt the same terms as the underlying primary policy.¹⁸¹ This was exemplified in the *XL Specialty* case,¹⁸² in which the U.S. District Court for the Southern District of New York held that the "severability of the exclusions" clause in a primary D&O insurance policy did not apply to two "follow-form" excess policies, and that the "severability of the application" clause in the primary policy was superseded by conflicting language in the two excess policies.

Standard Side A excess coverage protects directors and officers only and is not shared with the company. However, it is important to note that the coverage available to any given director or officer insured under a Side A-only policy may be diluted because other directors and officers share in the policy coverage.¹⁸³ Accordingly, a large claim involving an officer, and corresponding defense costs, could erode the coverage available to outside directors under the policy. Side

A excess coverage can be structured so that the coverage is nonrescindable for any reason (except nonpayment of premiums). A relatively newer form of coverage available in the market is so-called "Side A Difference-in-Conditions" coverage. Sometimes referred to as "Excess DIC Side A," the "difference-in-conditions" component broadens the standard Side A excess coverage. Excess DIC Side A usually is written at a very high excess "attachment" level, and dedicated to the coverage of directors and officers in the event of a catastrophic loss. Excess DIC Side A coverage typically is written that it "drops down" to act as primary coverage in the event that the company refuses or is unable (whether due to insolvency or otherwise) to indemnify, or where the underlying insurers have denied or rescinded coverage, where the underlying insurers have become insolvent, or where one or more of the underlying policies are unavailable due to bankruptcy. Finally, Excess DIC Side A typically is nonrescindable and includes full severability language.ⁿ¹⁸⁴

Another new form of coverage, less prevalent among public companies,ⁿ¹⁸⁵ is so-called "Independent Director Liability" ("IDL") coverage, which, like Excess DIC Side A coverage, is excess coverage that attaches at very high levels. It typically provides "drop down" protection when the underlying insurance is unavailable, either because the underlying insurer has denied or rescinded coverage, one or more of the underlying carriers has become insolvent, or one or more of the underlying policies have been stayed by a bankruptcy court. In addition, IDL policies can be structured so that they are nonrescindable, and many IDL policies do not contain exclusions normally found in traditional D&O insurance policies or contain narrower exclusions.ⁿ¹⁸⁶ IDL coverage is reserved for nonmanagement directors of a company and is available in several forms. Some IDL policies cover an individual director for all, or a combination of, the boards on which the director sits, while other policies cover all of the nonmanagement directors of a single company with respect to the directors' service on that company's board. IDL coverage can be purchased by a company or by directors themselves. To date, relatively few companies and directors have purchased IDL, and its utility therefore cannot be assessed with any reliability. IDL coverage may, however, prove useful in addressing the risk of dilution present with supplemental Side A coverage because that coverage is shared with other directors and officers.

Yet another new form of D&O insurance policy covers former directors and officers once they leave a corporation. Until applicable statutes of limitations have run, a former director or officer could be subject to potential claims based on acts or omissions that occurred while he or she was still at the corporation. Because D&O insurance policies are "claims-made" policies, the policy or policies that would apply to these claims is whatever the corporation has in effect at the time the claims are brought. In addition, a company's financial condition--and therefore, its ability to pay indemnification--could change during the period after a director or officer leaves the corporation. A retired director or officer liability policy is designed to address these issues. It can be structured to provide coverage with respect to service at a single company or at multiple companies. The policy is noncancelable and nonrescindable and does not include most of the exclusions of a traditional D&O policy.ⁿ¹⁸⁷ Like IDL coverage, because retired director and officer liability policies are specific to an individual, they remove the potential for dilution that exists with supplemental Side A coverage. Given the relatively recent introduction of retired director and officer liability policies into the marketplace, it is not yet clear how common they will become.

Supplemental Side A coverage is an increasingly common component of a well-constructed D&O insurance program. Companies considering the purchase of supplemental Side A coverage should be mindful that terms and conditions differ from one policy to the next, and that policy language can be negotiated. Companies also should be aware, as noted above, that terms and conditions in excess D&O insurance policies do not automatically "follow form" over the underlying primary policy. Even if an excess policy does "follow form," an excess insurer is not necessarily bound by the actual or implied coverage decisions of the primary carrier. In *Allmerica Financial Corporation v. Certain Underwriters at Lloyd's, London*,ⁿ¹⁸⁸ Allmerica sought payment from its primary and excess insurers following settlement of a class action lawsuit. The excess insurance policy at issue in the case was a "follow-form" policy. The primary insurer in Allmerica paid out the full amount of the policy, but the excess insurer denied coverage on the basis that certain policy exclusions applied. The Supreme Court of Massachusetts held that the excess insurer was not bound by the actual or implied coverage decisions of the primary insurer. The "follow-form" nature of the policy did not change the fact that the excess policy was a distinct agreement.

In addition, companies should pay particular attention to the "trigger" language in excess policies, which establishes when coverage becomes available under the policies. Excess policies will often state that coverage attaches only after the underlying insurance has been exhausted by the actual payment of losses by the insurers. This language can be problematic where an underlying insurer does not pay, whether due to a coverage dispute, financial inability or insolvency, or otherwise. For example, if an insured settles a claim within the limits of its primary policy, pays the difference on the claim up to the primary policy limits, and seeks coverage from its excess insurers for payments in excess of those limits, coverage may not be available because the policy language stipulates that the insurers must have paid up to the underlying policy limits.

This outcome has occurred recently in cases involving excess policies that contained this type of language. In a 2008 case involving Qualcomm, Inc.,¹⁸⁹ a California appellate court held that Qualcomm's excess insurer had no legal obligation to cover a claim where the company had settled with an underlying insurer for a payment that was less than full policy limits. There, Qualcomm's primary insurance had an aggregate limit of \$20 million, and the settlement with the insurer resulted in a payment of \$16 million, leaving a "gap" of \$4 million. Although it was undisputed that Qualcomm had additional settlement and defenses costs of over \$12 million, the court concluded that the excess insurer should bear no coverage obligation for any of that amount. The court stated that the "exhaustion clause here compels us to conclude that the parties expressly agreed that [the primary insurer] was required to pay (or be legally obligated to pay) no less than \$20 million as a condition of [the excess insurer's] liability."¹⁹⁰ The *Qualcomm* decision followed a similar ruling by a Michigan court in mid-2007 in a coverage dispute involving an excess policy issued to Comerica Inc.¹⁹¹

In view of these considerations, it is critical to scrutinize the policy language carefully and understand what is and is not covered. Due to the complexity of policy language and the issues involved, expert advice from qualified insurance and legal professionals can be important in obtaining a thorough understanding of the coverage available under a company's D&O insurance program. A growing number of boards of directors are seeking comprehensive analyses of their companies' D&O insurance programs, undertaken with the assistance of experts, in connection with the purchase or renewal of D&O insurance coverage. According to one survey of more than 700 corporate directors, approximately 81% indicated that their boards reviewed the company's D&O insurance policies annually.¹⁹²

Legal Topics:

For related research and practice materials, see the following legal topics:

Insurance LawBusiness InsuranceDirectors & Officers Liability InsuranceCoverageGeneral OverviewInsurance LawBusiness InsuranceDirectors & Officers Liability InsuranceCoverageSecurities ViolationsInsurance LawBusiness InsuranceDirectors & Officers Liability InsuranceCoverageWrongful ActsInsurance LawBusiness InsuranceDirectors & Officers Liability InsuranceExclusionsGeneral OverviewInsurance LawBusiness InsuranceDirectors & Officers Liability InsuranceExclusionsDishonestyInsurance LawBusiness InsuranceDirectors & Officers Liability InsuranceExclusionsInsured Versus Insured ExclusionsInsurance LawBusiness InsuranceDirectors & Officers Liability InsuranceObligationsIndemnification

FOOTNOTES:

(n1)Footnote 1. *In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 469 (S.D.N.Y. 2005) .

(n2)Footnote 2. *See Del. Code Ann. tit. 8, § 145(g)* (2009).

(n3)Footnote 3. *See, e.g.,* William Cotter, Jr., *The Changing State of D&O Insurance*, 11 *The Corporate Governance Advisor* No. 1, at 8 (Jan./Feb. 2003). For a brief history of the changing marketplace for D&O insurance, *see* John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 12:2 (Thomson West 2003 & Supp. 2008-09 revision by Jennifer Berger & Mitchell A. Kaufman)).

(n4)Footnote 4. See William Cotter, Jr., *The Changing State of D&O Insurance*, 11 *The Corporate Governance Advisor* No. 1, at 8-10 (Jan./Feb. 2003); see also John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 12:2 (Thomson West 2003 & Supp. 2008-09) (revision by Jennifer Berger & Mitchell A. Kaufman)).

(n5)Footnote 5. See William Cotter, Jr., *The Changing State of D&O Insurance*, 11 *The Corporate Governance Advisor* No. 1, at 8-10 (Jan./Feb. 2003); see also John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 12:2 (Thomson West 2003 & Supp. 2008-09) (revision by Jennifer Berger & Mitchell A. Kaufman)); Michael L. Gassmann, *D&O Insurance After Enron*, 10 *The Corporate Governance Advisor* No. 3, at 27-29 (May/June 2002).

(n6)Footnote 6. See, e.g., Kevin LaCroix, *The D&O Diary: First Quarter 2009 Securities Lawsuit Filings Up* (May 4, 2009), available at <http://www.dandodiary.com/2009/05/articles/securities-litigation/first-quarter-2009-securities-lawsuit-filings-up> (noting that the annualized number of securities class action lawsuits filed in 2009 based on first quarter filings is 268, "which would not only represent a significant increase over 2008 but would even be greater than the 'relatively litigious year of 2004.'"); PricewaterhouseCoopers, *2008 Securities Litigation Study 5 -6*, available at <http://10b5.pwc.com/pdf/ny-09-0894%20securities%20lit%20study%20final.pdf> (noting, among other things, that 210 federal securities class actions were filed in 2008, which was 29% higher than the number filed in 2007).

(n7)Footnote 7. See, e.g., Towers Perrin, *Directors and Officers Liability, 2007 Survey of Insurance Purchasing and Claims Trends 7-8*, available at http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf (noting that in 2007, survey participants reported lower premiums and retentions and an increase in coverage enhancements).

(n8)Footnote 8. See, e.g. Russ Banham, *A Tale of Two Markets*, CFO Magazine, available at <http://www.cfo.com/article.cfm/1335688> (Apr. 1, 2009); Kevin LaCroix, *The D&O Diary: Subprime Lawsuits Mount, So What About D&O Pricing?* (Aug. 27, 2008), available at <http://www.dandodiary.com/2008/08/articles/d-o-insurance/subprime-lawsuits-mount-so-what-about-do-pricing>; Zach Phillips, *Prices Firming Across D&O Sector*, Business Insurance (Mar. 16, 2009); Mike Schwander and Ken Capone, *D&Oh no! D&O Price Declines Come to a Halt as Class-Action Lawsuits Take Their Toll*, Entrepreneur (Apr. 15, 2009), available at <http://www.entrepreneur.com/tradejournals/article/198471556.html>.

(n9)Footnote 9. See, e.g., Stephen J. Weiss, *Due Diligence on D&O*, 28 *Directors and Boards* 3 (Spring 2004) (discussing six insurance questions directors should ask before joining a board).

(n10)Footnote 10. Michael L. Gassmann, *D&O Insurance After Enron*, 10 *The Corporate Governance Advisor* No. 3, at 27, 29 (May/June 2002).

(n11)Footnote 11. See Kevin LaCroix, *The D&O Diary: What Do D&O Insurers Look For?* (May 22, 2008), available at <http://www.dandodiary.com/2008/05/articles/d-o-insurance/what-do-do-insurers-look-for> (stating that "most underwriters understand that standard corporate governance practices alone are no guarantors that a company will not be involved in a claim. But by the same token, underwriters understand that companies that are actively implementing best practices are the kinds of companies that are interested in trying to play by the rules and perhaps less likely to have problems elsewhere-and better able to defend themselves if a claim does arise."); Towers Perrin, *Directors and Officers Liability, 2006 Survey of Insurance Purchasing and Claims Trends 56*, available at http://www.towersperrin.com/tp/getwebcachedoc?webc=HRS/USA/2007/200704/DO_Survey_Report2006_040507.pdf (stating that "D&O insurers' use of independent corporate governance ratings as part of their underwriting has grown" and that "[g]ood corporate governance may reduce both the liability risk and the premium an underwriter will charge for D&O insurance"); see also Fred T. Podolsky & Susanne Murray, Hilb Rogal & Hobbs, *2005 Directors and Officers Liability Snapshot and Insurance Market Forecast 7*, available at

<http://www.directorsandboards.com/DBEBRIEFING/JANUARY2005/DO2005FORECAST.PDF> ("Corporate governance is ... a focus of D&O underwriting and D & O risk evaluation.").

(n12)Footnote 12. For a more detailed discussion of these and other factors relevant to the D&O insurance underwriting process, see Kevin LaCroix, *The D&O Diary: What Do D&O Insurers Look For?* (May 22, 2008), available at <http://www.dandodiary.com/2008/05/articles/d-o-insurance/what-do-do-insurers-look-for/>.

(n13)Footnote 13. See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer* (Nov. 17, 2006) (discussing role that insurers might provide as a check on defense costs by conditioning coverage on governance-related remedial or preventative measures).

(n14)Footnote 14. See § 5.04[3][a] below (discussing the structure of the typical D&O insurance policy).

(n15)Footnote 15. See discussion of supplemental coverage in § 5.04[7] below . In addition to Side A coverage, more companies have reported considering independent director liability policies, although only a small number of companies have purchased such policies. See Towers Perrin, *Directors and Officers Liability, 2007 Survey of Insurance Purchasing and Claims Trends 22*, available at http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf.

(n16)Footnote 16. See, e.g., *Del. Code Ann. tit. 8, § 145(a)* (2009).

(n17)Footnote 17. *Del. Code Ann. tit. 8, § 145(b)* (2009).

(n18)Footnote 18. See discussion in § 5.03[4] above.

(n19)Footnote 19. See, e.g., *TLC Beatrice Int'l Holdings, Inc. v. CIGNA Ins. Co.*, 1999 U.S. Dist. LEXIS 605 , at *13-*20 (S.D.N.Y. Jan. 27, 1999) (New York court interpreting Delaware law concluded that omission of judgment and settlement amounts in derivative suits under Section 145(b) was intentional, rejected argument that indemnification was permitted under Section 145(f), and held that Delaware law does not empower corporations to indemnify directors for settlement amounts in derivative suits); *Arnold v. Society for Sav. Bancorp, Inc.*, 678 A.2d 533, 540 & n.18 (Del. 1996) (noting that Section 145(b) was intentionally drafted to avoid a circular result where a corporation would simply be paying itself for injury caused to it by the very directors being indemnified by the corporation); but see *Heffernan v. Pacific Dunlop GNB Corp.*, 1993 U.S. Dist. LEXIS 5, at *15 (N.D. Ill. Jan. 5, 1993) (Illinois court interpreting Delaware law and upholding bylaw provision permitting indemnification for charges, costs, judgments, fines, and amounts paid to settle suits by or on behalf of a corporation because Delaware statutory law "does not mark the exclusive ambit of indemnification rights" and statutory indemnification rights "co-exist with" rights conferred under corporate bylaws); see also S. Samuel Arshat & Walter K. Stapleton, *Delaware's New Corporation Law, Substantive Changes*, 23 *Bus. Law.* 75, 79-80 (1967) (indicating that the Delaware Corporation Law Revision Committee decided that to "permit the corporation to nullify a judgment in its favor against a director simply by refunding the director's payment on it would, in the committee's judgment, subvert the substantive provisions of the corporation law and should not be permitted." With respect to settlement amounts, the Committee thought that to permit indemnification "would have the ultimate effect of discouraging settlements since, in such a situation, derivative plaintiffs could demonstrate no benefit arising to the corporation from their action and, presumably, could not justify being reimbursed for their litigation expenses, including counsel fees.").

(n20)Footnote 20. *Globus, Inc. v. Law Research Serv., Inc.*, 418 F.2d 1276, 1289 (2d Cir. 1969) ; see also Joseph W. Bishop, Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 *Duke L.J.* 1153, 1161-66 (1972) (quoting *Brief for SEC as Intervenor, Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) , in which the SEC relied on the Second Circuit's position in *Globus*). But see *Fromer v. Yogel*, 50 F. Supp. 2d 227, 237-40 & n.8 (S.D.N.Y. 1999) (denying motion to dismiss claim for indemnification for liability arising under Section 10(b) of 1934 Act and suggesting, in reliance on *Globus*, that although indemnification is unavailable where an individual has knowingly and willfully violated the federal

securities laws, it may be available where a party that has been found jointly liable is without fault) (citing *Globus, Inc. v. Law Research Serv., Inc.*, 287 F. Supp. 188, 199 (S.D.N.Y. 1968), *aff'd in relevant part*, *rev'd in part on other grounds*, 418 F.2d 1276, 1288-89 (2d Cir. 1969)).

(n21)Footnote 21. 17 C.F.R. § 229.510 (2009).

(n22)Footnote 22. See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 286, 301 (3d Cir. 2001) ("[F]ederal courts disallow claims for indemnification because such claims run counter to the policies underlying the [1933 and 1934 Acts]."); *In re Enron Corp. Securities, Derivative & "ERISA" Litig.*, 2008 U.S. Dist. LEXIS 48516, at *51-53 (S.D. Tex. June 24, 2008) (citing various courts' discussions on indemnification under the 1933 and 1934 Acts); *Globus, Inc. v. Law Research Serv., Inc.*, 287 F. Supp. 188, 198-99 (S.D.N.Y. 1968), *aff'd in part*, *rev'd in part on other grounds*, 418 F.2d 1276 (2d Cir. 1969). Some courts have gone further and concluded that there is no right to indemnification of any kind under the 1934 Act. See, e.g., *Eichenholtz v. Brennan*, 52 F.3d 478, 483-85 (3d Cir. 1995) ("[I]ndemnification runs counter to the policies underlying the 1933 and 1934 Acts," which is "encouraging diligence and discouraging negligence in securities transactions."); *In re United States Oil & Gas Litig.*, 967 F.2d 489, 495 (11th Cir. 1992) ("Indemnification claims are not cognizable under the Securities Acts of 1933 and 1934."). At least one court has also extended the public policy limitations on indemnification to the proxy rules. In *Gould v. American-Hawaiian Steamship Co.*, the court concluded that indemnification was not available on public policy grounds where the defendants had violated Rule 14a-9 because Section 14(a) reaches negligent as well as deliberately deceptive conduct. *Gould v. American Hawaiian S.S. Co.*, 387 F. Supp. 163, 167 (D. Del. 1974), *vacated on other grounds*, 535 F.2d 761 (3d Cir. 1976). Stating that most of the cases on indemnity under the federal securities laws could be read to support the proposition that an unsuccessful defendant may obtain indemnity from a significantly more culpable defendant, the court concluded that the justification for permitting a shifting of liability was more compelling where a violation of the antifraud provisions of the federal securities was involved because these provisions implicate fraudulent and intentional misconduct. *Gould*, 387 F. Supp. at 167. By contrast, the court reasoned that the purpose of Section 14(a) was "regulatory, not compensatory ... Thus, the question of who pays the damages to the plaintiffs is of as great concern as the issue of whether the plaintiffs are compensated at all. To allow indemnity to those who have breached responsibilities squarely placed upon them by statute would vitiate the remedial purposes of § 14(a). Only a realistic possibility of liability for damages will encourage due diligence by those who solicit proxies and will protect the interest of informed corporate suffrage." *Gould*, 387 F. Supp. at 168.

(n23)Footnote 23. See, e.g., Stephen M. Cutler, Speech Before the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), *available at* <http://www.sec.gov/news/speech/spch042904smc.htm> (noting the SEC's adoption of this policy as a means "to enhance deterrence and accountability").

(n24)Footnote 24. See Floyd Norris, *6 From Xerox to Pay SEC \$22 Million*, N.Y. Times, June 6, 2003, at C1 (quoting a Xerox Corporation official who stated that "[s]ince these individuals were not found guilty of any wrongdoing, under the bylaws of the company, Xerox is required indemnify them for legal fees and disgorgement"); Press Release, SEC, *Six Former Senior Executives of Xerox Settle SEC Enforcement Action Charging Them With Fraud* (June 5, 2003), *available at* <http://www.sec.gov/news/press/2003-70.htm>; SEC v. Paul A. Allaire et al., Litigation Release No. 18174 (June 5, 2003).

(n25)Footnote 25. William H. Donaldson, Remarks Before the New York Financial Writers Association (June 5, 2003), *available at* <http://www.sec.gov/news/speech/spch060503whd.htm>.

(n26)Footnote 26. See J. David Washburn & Alexander M. Szeto, *Indemnification of Directors & Officers: A Different Side to the Problem of Corporate Corruption*, 8 Wall Street Lawyer No. 1, at 10, 13 (June 1, 2004) (stating that the SEC "is now using settlements to advance reform in the area of indemnification ... quietly reforming its settlement agreements to include provisions that make it difficult, if not impossible, for directors and officers to escape liability for their actions").

(n27)Footnote 27. See SEC v. Lucent Technologies Inc. *et al.*, Litigation Release No. 18715 (May 17, 2004).

(n28)Footnote 28. Press Release, SEC, *Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud* (May 17, 2004), available at <http://www.sec.gov/news/press/2004-67.htm>.

(n29)Footnote 29. Bruce Carton, *The Cost of Indemnification*, in Institutional Shareholder Services Class Action Services Alert (June 2004), available at http://www.riskmetrics.com/2004/06/the_cost_of_indemnification.html.

(n30)Footnote 30. See § 5.04[4][b] below (discussing exclusions applicable to insider trading profits and improper personal profits).

(n31)Footnote 31. For a discussion of the extent to which insurance may provide coverage for violations of the Sarbanes-Oxley Act, see John C. Tanner & David E. Howard, *Blowing Whistles and Climbing Ladders: The Hidden Insurance Issues Behind Sarbanes-Oxley and Recent Corporate Governance Reform*, 23 ACC Docket No. 4, at 32 (Apr. 2005); Carl E. Metzger & Jennifer L. Chunias, *Two Years After Sarbanes-Oxley: Assessing the Impact on D&O Liability Insurance*, 37 The Review of Secs. and Commodities Regulation No. 10, at 99 (May 26, 2004).

(n32)Footnote 32. 15 U.S.C. § 7242 (2009); see also 17 C.F.R. § 240.13b2-2 (2009) (SEC implementing rules).

(n33)Footnote 33. 15 U.S.C. § 7243 (2009).

(n34)Footnote 34. 15 U.S.C. § 7241 (2009) (Section 302); see also 17 C.F.R. §§ 240.13a-14 & 15d-14 (2009) (SEC rules implementing Section 302); 18 U.S.C. § 1350 (2009) (Section 906).

(n35)Footnote 35. 15 U.S.C. § 7244(a) (2009); see also 17 C.F.R. §§ 245.100-245.104 (2009) (SEC implementing rules).

(n36)Footnote 36. 18 U.S.C. § 1519 (2009).

(n37)Footnote 37. 18 U.S.C. § 1514A (2009) (Section 806); 18 U.S.C. § 1513(e) (2009) (Section 1107).

(n38)Footnote 38. See, e.g., *Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 6 Misc. 3d 1020A, 800 N.Y.S.2d 358 (July 8, 2003), *aff'd in part, rev'd in part*, 10 A.D.3d 528, 782 N.Y.S. 2d 19 (N.Y. App. Div. 2004). In *Vigilant*, the Supreme Court of New York held that, for public policy reasons, Credit Suisse First Boston could not recoup from its insurers \$70 million in disgorgement paid to settle an SEC action. According to the court, allowing Credit Suisse to pass the burden of settlement on to the company's insurers would: (1) defeat the policy behind disgorgement, which was to deprive Credit Suisse of money it had obtained unjustly and to deter similar future conduct; and (2) defeat the purpose of the final judgment ordering the disgorgement in the SEC action. Although the judgment was not a final adjudication of wrongdoing by Credit Suisse, the judgment specifically linked the disgorgement payment to the improper activity alleged by SEC. The court did allow Credit Suisse to recover the costs of defending the SEC action because, under the language of the insurance policy, the term "Loss" was defined to include defense costs. On appeal, the Supreme Court of New York, Appellate Division, affirmed the trial court's decision that Credit Suisse was not entitled to insurance coverage for the \$70 million disgorgement payment, stating that "[t]he risk of being directed to return improperly acquired funds is not insurable." *Vigilant*, 10 A.D.3d at 528. The Appellate Division reversed the part of the trial court order that permitted Credit Suisse to recover its defense costs incurred in the SEC action. *Vigilant*, 10 A.D.3d at 529. In reaching this conclusion, the Appellate Division relied on the definition of the term "Loss," which excluded matters uninsurable under the law governing the insurance policy. The Appellate Division also relied on the fact that the policy was a "no-duty-to-defend" policy, stating that, although insurers may be required to advance defense costs under such a policy, an insured must repay the advances upon a finding that the insured is not entitled to payment of a "Loss." *Vigilant*, 10 A.D.3d at 529. See also *Level 3 Comms., Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001) (claim for securities fraud did not constitute a loss under terms of D&O insurance policy because court found that insured was essentially seeking restitution for ill-gotten gains). The drafters of Section 145(g)

of the Delaware General Corporation Law specifically intended that the availability of insurance under this provision be limited by public policy considerations. See S. Samuel Arsht, *Indemnification Under Section 145 of Delaware General Corporation Law*, 3 *Del. J. Corp. L.* 179-180 (1978); see also E. Norman Veasey et al., *Delaware Supports Directors With a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 *Bus. Law.* 399, 418 & n.68 (citing same and noting that D&O insurance policies routinely provide that no payment will be made for claims deemed "uninsurable" under state law) (citations omitted).

(n39)Footnote 39. A 2008 decision of the U.S. Court of Appeals for the Eighth Circuit underscores the importance of carefully reading and understanding the actual language of a D&O insurance policy and not simply relying on intent or industry understanding. In *In re SRC Holding Corp.*, which involved claims against a financial services company and certain of its directors and officers for alleged wrongful acts in connection with the company's underwriting and sale of municipal bonds, the court held that a securities claim exclusion in the company's D&O insurance policy precluded coverage for all securities claims despite evidence that the exclusionary language was generally thought in the industry to exclude coverage only for liability resulting from the insured's sale of its own securities. See *In re SRC Holding Corp.*, 545 F.3d 661 (8th Cir. 2008). See also Kevin LaCroix, *The D&O Diary: D&O Insurance Policy Wordings, Exclusionary Preambles and Securities Claims* (Nov. 30, 2008), available at <http://www.dandodiary.com/2008/11/articles/d-o-insurance/do-insurance-policy-wordings-exclusionary-preambles-and-securities-claims> (discussing case).

(n40)Footnote 40. See discussion in § 5.04[6] below.

(n41)Footnote 41. See § 5.04[7] below (discussing supplemental insurance coverage).

(n42)Footnote 42. Some examples of non-indemnifiable losses include judgments or settlements in derivative actions, losses related to certain violations of the federal securities laws (where indemnification would be against public policy), losses that the corporation is financially unable to fund and losses for which applicable law or the corporation's certificate of incorporation or bylaws prohibit indemnification.

(n43)Footnote 43. See John C. Tanner & David E. Howard, *Blowing Whistles and Climbing Ladders: The Hidden Insurance Issues Behind Sarbanes-Oxley and Recent Corporate Governance Reform*, 23 ACC Docket No. 4, at 32, 34-35, 48-49 (Apr. 2005) (stating that the heightened regulatory climate brought about by the Sarbanes-Oxley Act has "dramatically increased public company D&O claim exposure to SEC and other governmental investigations" and advising companies to see that their policies provide maximum coverage for investigations). See also, e.g., Patricia A. Bronte, *D&O Coverage for Corporate Criminal Investigations*, 7 *The Insurance Law Coverage Bulletin* No. 11 (Dec. 2008) (discussing cases that have analyzed whether a corporate criminal investigation constitutes a "claim"); Robert D. Chesler & Cindy Tzvi Sonenblich, *Does a Subpoena Constitute a 'Claim' for Purposes of D&O Insurance Coverage?*, 14 MEALEY's Emerging Insurance Disputes No. 2 (Jan. 21, 2009) (discussing cases that have analyzed whether a subpoena constitutes a "claim").

(n44)Footnote 44. See, e.g., Federal Insurance Company Executive Liability Coverage Policy (quoted in *Federal Ins. Co. v. Kozlowski*, 18 A.D.3d 33, 792 N.Y.S. 2d 397, 399 (N.Y. App. Div. 2005) and *In re Healthsouth Corp. Ins. Litig.*, 308 F. Supp. 2d 1253, 1260-61 (N.D. Ala. 2004)).

(n45)Footnote 45. See *Golf Course Superintendents Assoc. of America v. Underwriters at Lloyd's London*, 761 F. Supp. 1485, 1489-91 (D. Kan. 1991); see also *New Hampshire Ins. Co. v. Westlake Hardware, Inc.*, 1999 U.S. App. LEXIS 30651, at *8-*13 (10th Cir. Nov. 26, 1999) (unpublished).

(n46)Footnote 46. Fiduciary liability coverage is available separately and is sometimes added to the D&O policy by endorsement.

(n47)Footnote 47. See Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 *Bus. Law.* 573, 599 (1996) (discussing cases).

(n48)Footnote 48. *See* § 5.04[3][b] *above*.

(n49)Footnote 49. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Briggs*, 464 N.W.2d 535, 539 (Minn. App. 1990) (holding insurer had no duty to indemnify officers for personal liability arising out of corporation's failure to pay withholding taxes because "insurance coverage for nonpayment of taxes would be contrary to public policy").

(n50)Footnote 50. *See, e.g., Mortenson v. National Union Fire Ins. Co.*, 249 F.3d 667 (7th Cir. 2001) (holding that statutory penalty imposed on corporate officer for willful nonpayment of corporation's payroll taxes was penalty within the meaning of "fines and penalties" exclusion in D&O insurance policy and explaining that certain types of insurance, such as insurance against civil and criminal fines, are against public policy because of "moral hazard" that having insurance may tempt insured to commit the very act insured against).

(n51)Footnote 51. *See* Joseph W. Bishop, Jr., *The Law of Corporate Officers and Directors: Indemnification and Insurance* § 8.9 (2008) (discussing matters that may be deemed uninsurable under state law and citing cases).

(n52)Footnote 52. *See, e.g., Biondi v. Beekman Hill House Apartment Corp.*, 257 A.D.2d 76, 692 N.Y.S. 2d 304 (N.Y. App. Div. 1999), *aff'd* 94 N.Y.2d 659, 709 N.Y.S.2d 861 (2000) (indemnification for punitive damages is barred by state public policy).

(n53)Footnote 53. *See* Michael J. Rosenhouse, Annotation, *Liability Insurance Coverage as Extending to Liability for Punitive or Exemplary Damages*, 16 A.L.R. 4th 11 § 2[a](1982 & Supp. 2009).

(n54)Footnote 54. *See, e.g., Whalen v. On-Deck, Inc.*, 514 A.2d 1072, 1074 (Del. 1986) (holding punitive damages insurable in the absence of contrary legislative intent and noting that insured may still be punished through higher premiums or loss of insurance altogether); *but see Home Ins. Co. v. American Home Products Corp.*, 75 N.Y.2d 196, 200-201, 551 N.Y.S.2d 481, 550 N.E.2d 930 (1990) (New York public policy prohibits insurance for punitive damages).

(n55)Footnote 55. *Country Mutual Ins. Co. v. Livorsi Marine, Inc.*, 856 N.E.2d 338 (Ill. 2006) .

(n56)Footnote 56. *Country Mutual*, 856 N.E.2d at 340 .

(n57)Footnote 57. *Country Mutual*, 856 N.E.2d at 340-41 .

(n58)Footnote 58. *Country Mutual*, 856 N.E.2d at 343-44 .

(n59)Footnote 59. *Country Mutual*, 856 N.E.2d at 346 .

(n60)Footnote 60. 2009 Tex. LEXIS 111, *2, 24-25 (Tex. Mar. 27, 2009) .

(n61)Footnote 61. *Prodigy*, 2009 Tex. LEXIS 111 at *4 .

(n62)Footnote 62. *Prodigy*, 2009 Tex. LEXIS 111 at *10-24 .

(n63)Footnote 63. *Prodigy*, 2009 Tex. LEXIS 111 at *24-25 .

(n64)Footnote 64. *Vigilant Ins. Co. v. Bear Stearns Cos.*, 10 N.Y.3d 170, 855 N.Y.S.2d 45, 884 N.E.2d 1044 (N.Y. 2008) .

(n65)Footnote 65. These exclusions are discussed in § 5.04[4][b] *below*.

(n66)Footnote 66. *See* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 Bus. Law. 573, 600 (1996).

(n67)Footnote 67. These exclusions are discussed in § 5.04[4][c] *below*.

(n68)Footnote 68. This exclusion is discussed in § 5.04[4][d] below.

(n69)Footnote 69. *National Union Fire Ins. Co. v. Brown*, 787 F. Supp. 1424, 1428 (S.D. Fla. 1991) , *aff'd* 963 F.2d 385 (11th Cir. 1992) (quoting policy).

(n70)Footnote 70. Leo M. Pruett *et al.*, *After Enron: Maximizing Coverage in a D&O Policy*, 20 No. 8 ACCA Docket 45, 52 & n. 21 (Sept. 2002) (quoting Griffin Comms., Inc., *The D&O Book: A Comparison Guide to Directors & Officers Liability Insurance Policies*, at DISHON-2 (2001)).

(n71)Footnote 71. For a discussion of the different types of policy language that can trigger the exclusion for criminal or fraudulent acts and other conduct-based exclusions, *see* Michael A. Rossi, *Rewriting the Rule Book on D&O Insurance*, XXVII The Risk Report No. 5, at 1, 3 (Jan. 2005), *available at* <http://www.lexis.com> (database: The Risk Report (IRMI)).

(n72)Footnote 72. 15 U.S.C. § 7242 (2009); *see also* 17 C.F.R. § 240.13b2-2 (2009) (SEC implementing rules).

(n73)Footnote 73. 18 U.S.C. § 1350 (2009).

(n74)Footnote 74. Because the exclusion for short-swing profits can be viewed as covered by the "personal profits" exclusion discussed below, some insurers no longer list it as a separate exclusion. John F. Olson *et al.*, *Director and Officer Liability: Indemnification and Insurance* § 12:12 n.2 (Thomson West 2003 & Supp. 2008-09 (revision by Jennifer Berger & Mitchell A. Kaufman)).

(n75)Footnote 75. 15 U.S.C. § 7243 (2009). *See, e.g.*, Carl E. Metzger & Jennifer L. Chunias, *Two Years After Sarbanes-Oxley: Assessing the Impact on D&O Liability Insurance*, 37 The Review of Secs. and Commodities Regulation No. 10, at 99, 105 (May 26, 2004) ("If disgorgement or repayment is ordered, this could be a sufficient finding that the director or officer was not 'legally entitled' to such amounts to trigger the [personal profits] exclusion.").

(n76)Footnote 76. 15 U.S.C. § 7244(a) (2009); *see also* 17 CFR §§ 245.100-245.104 (2009) (SEC implementing rules). *See, e.g.*, Carl E. Metzger & Jennifer L. Chunias, *Two Years After Sarbanes-Oxley: Assessing the Impact on D&O Liability Insurance*, 37 The Review of Secs. and Commodities Regulation No. 10, at 99, 105 (May 26, 2004) ("Sarbanes-Oxley has made this exclusion more important in cases in which a claim is made against a director or officer for trading stock during a blackout period as defined in the Act.").

(n77)Footnote 77. *See TIG Specialty Ins. Co. v. PinkMonkey.com Inc.*, 375 F.3d 365 (5th Cir. 2004) , *reh'g denied*, 115 Fed. Appx. 766 (5th Cir. 2004) .

(n78)Footnote 78. *TIG Specialty*, 375 F.3d at 368 .

(n79)Footnote 79. *TIG Specialty*, 375 F.3d at 370-371 .

(n80)Footnote 80. *TIG Specialty*, 375 F.3d at 371-372 .

(n81)Footnote 81. *TIG Specialty*, 375 F.3d at 372 .

(n82)Footnote 82. *TIG Specialty*, 375 F.3d at 372 .

(n83)Footnote 83. Severability and rescission are discussed in more detail in § 5.04[6] below.

(n84)Footnote 84. *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908, 910 (7th Cir. 2001) .

(n85)Footnote 85. *Kiewit Diversified Group v. Federal Ins. Co.*, 999 F. Supp. 1169 (N. Ill. 1998) .

(n86)Footnote 86. *Level 3*, 272 F.3d at 910 .

(n87)Footnote 87. *Level 3*, 272 F.3d at 911 (giving as an example a situation where a corporation is sued for a fraudulent statement made by an officer that inflates the corporation's stock price without conferring a measurable benefit to the corporation).

(n88)Footnote 88. *Conseco, Inc. v. National Union Fire Ins. Co.*, 2002 WL 31961447 (Ind. Cir. Ct. Dec. 31, 2002).

(n89)Footnote 89. *Conseco*, 2002 WL 31961447 at *5.

(n90)Footnote 90. *CNL Hotels & Resorts, Inc. v. Houston Cas. Co. and Landmark American Ins. Co.*, 505 F. Supp. 2d 1317 (M.D. Fla. 2007) , *aff'd in relevant part, rev'd in part* 2008 U.S. App. LEXIS 17686 (11th Cir. Aug. 18, 2008) .

(n91)Footnote 91. *CNL Hotels*, 505 F. Supp. at 1318 .

(n92)Footnote 92. *CNL Hotels*, 505 F. Supp. 2d at 1322 (citations omitted) .

(n93)Footnote 93. *CNL Hotels & Resorts, Inc. v. Houston Cas. Co. and Landmark American Ins. Co.*, 2008 U.S. App. LEXIS 17686 (11th Cir. Aug. 18, 2008) .

(n94)Footnote 94. *Bank of America Corp. v. SR Int'l Bus. Ins.*, 2007 NCBC 36 (N.C. Super. Ct. Dec. 19, 2007) (unpublished) (applying North Carolina law).

(n95)Footnote 95. *Bank of America*, 2007 NCBC 36 at *49 .

(n96)Footnote 96. *Bank of America*, 2007 NCBC 36 at *50 .

(n97)Footnote 97. In *Massachusetts v. EPA*, the U.S. Supreme Court held that greenhouse gas emissions are "pollutants" under the Clean Air Act. 549 U.S. 497, 127 S. Ct. 1438, 1462 (2007) . Since that decision, some commentators have raised the question of whether the pollution exclusion will result in successful denials of insurance coverage for securities claims based on, for example, inadequate disclosures or misrepresentations regarding climate change. See, e.g., Erin Coe, *Global Warming Raises Risks for Directors, Officers*, Law360 (Oct. 14, 2008), available at <http://www.tsmp.com/files/News/55267008-9d1a-40ca-84ce-0100c2c2e9f8/Presentation/NewsAttachment/72a03b07-99dd-4925-8c54-0> Kevin LaCroix, *The D&O Diary: Climate Change and D&O Risk* (April 9, 2007), available at <http://www.dandodiary.com/2007/04/articles/environmental-liability/climate-change-and-d-o-risk/>. In 2008, a New Jersey intermediate appellate court affirmed a trial court decision answering "no" to that question and holding that the pollution exclusion would not bar insurance coverage for a securities class action lawsuit alleging misrepresentation of asbestos-related claims. *Sealed Air Corp. v. Royal Indem. Co.*, 961 A.2d 1195 (N.J. Super. Ct. App. Div. 2008) .

(n98)Footnote 98. 2006 U.S. Dist LEXIS 78329 (D. Oregon July 19, 2006) .

(n99)Footnote 99. 2006 U.S. Dist LEXIS 78329, at *2 .

(n100)Footnote 100. 2006 U.S. Dist LEXIS 78329, at *2-3 .

(n101)Footnote 101. 2006 U.S. Dist LEXIS 78329, at *8-9 .

(n102)Footnote 102. See *Cohen v. National Union Fire Ins. Co. (In re County Seat Stores, Inc.)*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002) (discussing decisions reaching opposite results).

(n103)Footnote 103. See *Cohen v. National Union Fire Ins. Co. (In re County Seat Stores, Inc.)*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002) ; *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 403-04 (D. Del. 2002) .

(n104)Footnote 104. See, e.g., *National Union Fire Ins. Co. v. Olympia Holding Corp.*, 1996 U.S. Dist. LEXIS 22806 (June 5, 1996); *Reliance Ins. Co. v. Weis*, 148 B.R. 575 (E.D. Mo. 1992), *aff'd in relevant part*, 5 F.3d 532 (8th Cir. 1993).

(n105)Footnote 105. For a more detailed discussion of rescission, see, e.g., Daniel Aronowitz, *The New Rescission Rules for D&O Insurance Policies*, 38 The Review of Secs. and Commodities Regulation No. 2, at 13 (Jan. 26, 2005); John C. Tanner, *So Long, D&O Coverage: Policy Rescission--What the Insured Can Do*, Business Law Today 54 (Mar./Apr. 2005); Murray D. Sacks & Kathrin V. Smith, *How to Fight the Rescission of a D&O Insurance Policy*, 17 Insights No. 7, at 2 (July 2003).

(n106)Footnote 106. The Homestore advancement proceedings are discussed in detail in § 5.03[5] above.

(n107)Footnote 107. See *Fed. Ins. Co. v. Homestore, Inc.*, 144 Fed. Appx. 641 (9th Cir. 2005); *TIG Ins. Co. of Michigan v. Homestore, Inc.*, 137 Cal. App. 4th 749 (2006).

(n108)Footnote 108. See *Fed. Ins. Co.*, 144 Fed. Appx. at 648.

(n109)Footnote 109. See, e.g., Daniel Aronowitz, *The New Rescission Rules for D&O Insurance Policies*, 38 The Review of Secs. and Commodities Regulation No. 2, at 13-17 (Jan. 26, 2005) (surveying state law). For example, as discussed above, California law, which governed Homestore's policies, requires that rescission apply to all insureds unless the policy provides otherwise. *Cal. Ins. Code* § 650 (2008).

(n110)Footnote 110. See Daniel Aronowitz, *The New Rescission Rules for D&O Insurance Policies*, 38 The Review of Secs. and Commodities Regulation No. 2, at 13-16 (Jan. 26, 2005). See, e.g., *Republic Ins. Co. v. Masters, Mates & Pilots Pension Plan*, 77 F.3d 48, 52 (2d Cir. 1996) (New York law) ("Under New York law ... an insurance policy issued in reliance on a material misrepresentation is void from its inception." (citations omitted)); see also *N.Y. Ins. Law* § 3105 (2009) (defining material misrepresentation); *Merced County Mutual Life Ins. Co. v. State of California*, 233 Cal. App. 3d 765, 771, 284 Cal. Rptr. 680 (1991) (California law) (citing *Cal. Ins. Code* § 359 (2009) ("If a representation is false in a material point, whether affirmative or promissory, the injured party is entitled to rescind the contract from the time the representation becomes false."). Under California law, "[t]he materiality of a representation is a question of law ... to be determined solely by the probable and reasonable effect which truthful answers would have had upon the insurer (Ins. Code § 334); i.e., was the insurer misled into accepting a risk, fixing the premium of insurance, estimating the disadvantages of the proposed contract or making his inquiries." *Merced*, 233 Cal. App. 3d 765 at 772 (citations omitted); see also *Cal. Ins. Code* § 334 (2008) ("Materiality is to be determined not by the event, but solely by the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries.").

(n111)Footnote 111. See Daniel Aronowitz, *The New Rescission Rules for D&O Insurance Policies*, 38 The Review of Secs. and Commodities Regulation No. 2, at 13, 15, 16-17 (Jan. 26, 2005). See, e.g., *Matinchek v. John Alden Life Ins. Co.*, 93 F.3d 96, 102 (3d Cir. 1996) (Pennsylvania law) ("Under Pennsylvania law, an insurance contract is void if (1) the representation was false; (2) the insured knew it to be false when made or acted in bad faith; and (3) the representation was material to the risk being insured." (citation omitted)); *Albany Ins. Co. v. Anh Thi Kieu*, 927 F.2d 882, 891 (5th Cir. 1991) (Texas law) ("Under Texas insurance law, an insurer may invalidate a policy of insurance on the basis of the insured's misrepresentations in the insurance application only if the insurer can successfully plead and prove the following five elements: (1) the making of the representation; (2) the falsity of the representation; (3) reliance thereon by the insurer; (4) the intent to deceive on the part of the insured in making same; and (5) the materiality of the representation The unique aspect of this Texas law is the requirement that the insurer plead and prove the insured's intent to deceive.' It is incumbent upon the insurer to prove that the insured made some material misrepresentation willfully and with design to deceive or defraud,' as an element of this [misrepresentation] defense.' " (citations omitted)).

(n112)Footnote 112. See John C. Tanner, *So Long, D&O Coverage: Policy Rescission--What the Insured Can Do*, Business Law Today 54, 55 (Mar./Apr. 2005).

(n113)Footnote 113. See Daniel Aronowitz, *The New Rescission Rules for D&O Insurance Policies*, 38 The Review of Secs. and Commodities Regulation No. 2, at 13, 21-24 (Jan. 26, 2005).

(n114)Footnote 114. See, e.g., John C. Tanner, *So Long, D&O Coverage: Policy Rescission--What the Insured Can Do*, Business Law Today 54, 55 (Mar./Apr. 2005).

(n115)Footnote 115. John C. Tanner, *So Long, D&O Coverage: Policy rescission--What the Insured Can Do*, Business Law Today 54, 57 (Mar./Apr. 2005).

(n116)Footnote 116. See *In re HealthSouth Corp. Ins. Litig.*, 308 F. Supp. 2d 1253, 1281 (N.D. Ala. 2004) . The clause in HealthSouth's policy provided that the "written application(s) for coverage shall be construed as a separate application for coverage by each of the Insured Persons. With respect to the declarations and statements contained in such written application(s) for coverage, no statement in the application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available." *HealthSouth*, 308 F. Supp. 2d at 1261 .

(n117)Footnote 117. *HealthSouth*, 308 F. Supp. 2d at 1280-1281 .

(n118)Footnote 118. *HealthSouth*, 308 F. Supp. 2d at 1281 .

(n119)Footnote 119. See, e.g., John C. Tanner, *So Long, D&O Coverage: Policy Rescission--What the Insured Can Do*, Business Law Today 54, 57-59 (Mar./Apr. 2005).

(n120)Footnote 120. *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988 (W.D. Wash. 2004) , *aff'd* 144 Fed. Appx. 600 (9th Cir. 2005) (unpublished).

(N121)Footnote 121. *Cutter & Buck*, 306 F. Supp. 2d at 1011 . The partial severability clause stated, in its entirety, that "[i]n the event that the Application, including materials submitted therewith, contains misrepresentations made with the actual intent to deceive, or contains misrepresentations which materially affect either the acceptance of the risk or the hazard assumed by the INSURER under this Policy, this Policy in its entirety shall be void and of no effect whatsoever; and provided, however, that no knowledge possessed by any DIRECTOR or OFFICER shall be imputed to any other DIRECTOR or OFFICER except for material information known to the person or persons who signed the Application. In the event that any of the particulars or statements in the Application is untrue, this Policy will be voided with respect to any DIRECTOR or OFFICER who knew of such untruth." *Cutter & Buck*, 306 F. Supp. 2d at 1011 .

(n122)Footnote 122. *Cutter & Buck*, 306 F. Supp. 2d at 1014 .

(n123)Footnote 123. See *Federal Ins. Co. v. Tyco Int'l Ltd.*, 2004 NY Slip Op. 50160U (Mar. 5, 2004), 784 N.Y.S.2d 920, 2004 N.Y. Misc. LEXIS 228 (unpublished), *aff'd in part on other grounds, rev'd in part on other grounds*, 18 A.D.3d 33, 792 N.Y.S. 2d 397 (N.Y. App. Div. 2005); *Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 382 F. Supp. 2d 685 (2004).

(n124)Footnote 124. *Federal Ins. Co.*, 2004 NY Slip Op. 50160U, at *7-8 (citations omitted).

(n125)Footnote 125. *Federal Ins. Co.*, 2004 NY Slip Op. 50160U, at *7 .

(n126)Footnote 126. *Federal Ins. Co.*, 2004 NY Slip Op. 50160U, at *7. See also *In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455 (S.D.N.Y. 2005) (ordering insurer to advance defense costs to former WorldCom director under excess D&O insurance policy because, until the issue of rescission is adjudicated, an insurance policy remains in

effect and the duty to pay defense costs is enforceable, and rejecting insurer's argument that director was required to demonstrate a likelihood of success in defeating rescission in order to be entitled to defense costs).

(n127)Footnote 127. *See Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 382 F. Supp. 2d 685 (2004) .

(n128)Footnote 128. *See 11 U.S.C. § 362(a)(3)* (2008).

(n129)Footnote 129. *See Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 2004 U.S. Dist. LEXIS 4498, at *12 (E.D. Pa. Mar. 17, 2004) ; *see also Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 2004 U.S. Dist. LEXIS 7027, at *3-4 (E.D. Pa. Apr. 8, 2004) ("This Court continues to conclude that [the automatic] stay precludes this Court from considering the issue of rescission.").

(n130)Footnote 130. *Associated Elec. & Gas*, 2004 U.S. Dist. LEXIS 4498, at *14-15 .

(n131)Footnote 131. *Associated Elec. & Gas*, 2004 U.S. Dist. LEXIS 4498, at *16 .

(n132)Footnote 132. *See Associated Elec. & Gas*, 2004 U.S. Dist. LEXIS 4498, at *19-41 .

(n133)Footnote 133. *Associated Elec. & Gas*, 2004 U.S. Dist. LEXIS 4498, at *42 ("although all five ... are defendants in numerous civil cases and, if found liable, would probably face judgments of many millions of dollars, at this moment they have not been found liable to anyone for anything").

(n134)Footnote 134. *See* discussion of conduct exclusions in § 5.03[4][b] above .

(n135)Footnote 135. *See* discussion of supplemental coverage in § 5.04[7] below .

(n136)Footnote 136. *See* John C. Tanner, *So Long, D&O Coverage: Policy Rescission--What the Insured Can Do*, Business Law Today 54, 59-60 (Mar./Apr. 2005) (discussing severability language in the context of excess policies and stating that "[e]xcess insurers are now routinely arguing that their policies do not 'follow form' over the primary policy's severability wording"); *see also* Kevin LaCroix, *The D&O Diary: Refco Bankruptcy and Excess Policy Coverage for Defense Fees* (Sept. 8, 2007), available at <http://www.dandodiary.com/2007/09/> (raising a growing concern that "follow-form" excess carriers are taking coverage positions that have not been asserted by the primary carriers).

(n137)Footnote 137. *See* discussion of supplemental coverage in § 5.04[7] below .

(n138)Footnote 138. *XL Specialty Ins. Co. v. John D. Agolia et al.*, 2009 U.S. Dist. LEXIS 36601 (S.D.N.Y. Apr. 30, 2009) .

(n139)Footnote 139. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *37 .

(n140)Footnote 140. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *37 n.12 .

(n141)Footnote 141. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *8-9 .

(n142)Footnote 142. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *32-33 .

(n143)Footnote 143. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *9-10 .

(n144)Footnote 144. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *10-11 .

(n145)Footnote 145. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *11 .

(n146)Footnote 146. *XL Specialty*, 2009 U.S. Dist. LEXIS 36601 at *50 .

(n147)Footnote 147. Even before the advent of entity coverage, courts disagreed about whether the proceeds of a combined policy--a policy with both "Side A" (direct liability) coverage and "Side B" (indemnification) coverage--should be considered estate property. *See, e.g., In re Allied Digital Technologies Corp.*, 306 B.R. 505, 511-12 (Bankr. Del. 2004) (discussing cases addressing the effect of Side B coverage).

(n148)Footnote 148. For a discussion of the effect of bankruptcy on the availability of Side A, Side B, and entity coverage under a D&O insurance policy, *see, e.g.,* Kimberly M. Melvin, *D&O Policy Proceeds as Bankruptcy Estate Assets: The Elusive Quest for Clarity*, 16 Coverage No. 3 (May/June 2006); Richard M. Cieri & Michael J. Riel, *Protecting Directors and Officers of Corporations that Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 *DePaul Bus. & Comm. L.J.* 295 (Winter 2004). *See also* William Cotter, Jr., *The Changing State of D&O Insurance*, 11 *The Corporate Governance Advisor* No. 1, at 8 (Jan./Feb. 2003) (discussing problems with entity coverage, in and outside of the bankruptcy context, and arguing that entity coverage has so diluted the coverage afforded to directors and officers under D&O insurance policies that it should be eliminated).

(n149)Footnote 149. *See National Century Fin. Enterprises, Inc. v. Gulf Ins. Co. (In re Nat'l Century Fin. Enters.)*, 2005 Bankr. LEXIS 1052 (S.D. Ohio Jan. 10, 2005) .

(n150)Footnote 150. *See e.g., Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1399-1400 (5th Cir. 1987) (citing *In re Davis*, 730 F.2d 176, 184 (5th Cir. 1984)) .

(n151)Footnote 151. *See, e.g., Louisiana World Exposition*, 832 F.2d at 1394 ; *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 216 (3d Cir. 2000) .

(n152)Footnote 152. *See, e.g., Youngstown Osteopathic Hosp. Ass'n v. Ventresco (In re Youngstown Osteopathic Hosp. Ass'n)*, 271 B.R. 544, 550 (Bankr. N.D. Ohio 2002) ("While [the debtor] is the named insured on the policy, the policy is for the benefit of the directors and officers.").

(n153)Footnote 153. *See* David H. Kistenbroker *et al.*, *Securities Litigation and Insolvency: The Case for the Director and Officer Insurance Proceeds*, 1269 *PLI/Corp.* 661, 681 n.69 (Practising Law Institute Securities Litigation 2001 Program Sept.-Oct. 2001) (in a typical indemnification provision, "[i]n essence, the proceeds merely 'pass through' the estate on their way to the directors and officers; the corporation never profits or 'comes out ahead' as a result of the payments").

(n154)Footnote 154. *See, e.g., MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 92 (2d Cir. 1988) ; *Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1401 (5th Cir. 1987) ; *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reins. Corp. (In re Minoco Group of Cos., Ltd.)*, 799 F.2d 517, 519 (9th Cir. 1986) ; *In re CyberMedica, Inc.*, 280 B.R. 12, 16 (Bankr. D. Mass. 2002) (citing cases); *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9, 15-16 (Bankr. E.D.N.Y. 1999) , *aff'd* 2000 U.S. Dist. LEXIS 22005 (E.D.N.Y. Mar. 2, 2000) .

(n155)Footnote 155. *See In re Adelpia Communs. Corp.*, 298 B.R. 49, 53 (Bankr. S.D.N.Y. 2003) (discussing cases reaching different results).

(n156)Footnote 156. *See In re CyberMedica, Inc.*, 280 B.R. 12, 16 (Bankr. D. Mass. 2002) ; *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999) , *aff'd*, 2000 U.S. Dist. LEXIS 22005 (E.D.N.Y. Mar. 2, 2000) .

(n157)Footnote 157. *See 11 U.S.C. § 362(a)(3) (2009)*.

(n158)Footnote 158. *Adelpia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (In re Adelpia Communications Corp.)*, 285 B.R. 580, 590-93 (Bankr. S.D.N.Y. 2002) , *vacated and remanded*, *In re Adelpia Communs. Corp.*, 298 B.R. 49 (Bankr. S.D.N.Y. 2003) .

(n159)Footnote 159. *Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (In re Adelphia Communications Corp.)*, 285 B.R. 580, 592 (Bankr. S.D.N.Y. 2002) , vacated and remanded, *In re Adelphia Communs. Corp.*, 298 B.R. 49 (Bankr. S.D.N.Y. 2003) .

(n160)Footnote 160. See *Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (In re Adelphia Communications Corp.)*, 285 B.R. 580, 600 (Bankr. S.D.N.Y. 2002) , vacated and remanded, *In re Adelphia Communs. Corp.*, 298 B.R. 49 (Bankr. S.D.N.Y. 2003) .

(n161)Footnote 161. See *In re Adelphia Communs. Corp.*, 298 B.R. 49 (Bankr. S.D.N.Y. 2003) . The court remanded the case for further findings to determine whether the stay under Section 362 of the U.S. Bankruptcy Code should be extended to stay litigation related to the D&O insurance policies. See *Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (In re Adelphia Communications Corp.)*, 302 B.R. 439 (Bankr. S.D.N.Y. 2003) .

(n162)Footnote 162. *In re Adelphia Communs. Corp.*, 298 B.R. 49, 53 (Bankr. S.D.N.Y. 2003) (quoting *Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (In re Adelphia Communications Corp.)*, 285 B.R. 580, 587 (Bankr. S.D.N.Y. 2002), vacated and remanded by 298 B.R. 49 (Bankr. S.D.N.Y. 2003)) .

(n163)Footnote 163. *In re Adelphia Communs. Corp.*, 298 B.R. 49, 53 (Bankr. S.D.N.Y. 2003) .

(n164)Footnote 164. *In re Adelphia Communs. Corp.*, 298 B.R. 49, 53 (Bankr. S.D.N.Y. 2003) . See also *Miller v. McDonald (In re World Health Alternatives, Inc.)*, 369 B.R. 805 (Bankr. D. Del. 2007) (federal bankruptcy court in Delaware held that bankruptcy trustee could not prevent a corporation's former directors and officers from using the D&O policy proceeds to settle claims against them since the policy proceeds being used to fund the settlement were from the policy's Side A coverage).

(n165)Footnote 165. See *In re Enron Corp.*, 2002 Bankr. LEXIS 544 (S.D.N.Y. May 17, 2002) .

(n166)Footnote 166. See *Adelphia Communications Corp. v. Associated Elec. & Gas Ins. Servs., Ltd. (In re Adelphia Communications Corp.)*, 285 B.R. 580, 597 n.25 (Bankr. S.D.N.Y. 2002) , vacated and remanded by 298 B.R. 49 (Bankr. S.D.N.Y. 2003) (citing Oral Decision, Tr. of Hrg. of Apr. 11, 2002 (ECF #3278), *In re Enron Corp.*, Case No. 01-16034 (AJG), at 13)).

(n167)Footnote 167. See Kimberly M. Melvin, *D&O Policy Proceeds as Bankruptcy Estate Assets: The Elusive Quest for Clarity*, 16 Coverage No. 3, n.40 & accompanying text (May/June 2006).

(n168)Footnote 168. See discussion in § 5.04[7] below.

(n169)Footnote 169. See, e.g., Towers Perrin, *Directors and Officers Liability, 2007 Survey of Insurance Purchasing and Claims Trends 23*, available at http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf (showing a 10% decline in the number of companies that purchased entity coverage in 2007 as compared to 2006).

(n170)Footnote 170. See, e.g., Carolyn H. Rosenberg, *Insuring Management in Crisis* 19-22 (Nov. 18, 2005), in Corporate Board Member 2005 Special Supplement: Boardroom Liabilities--Shielding Directors from Harm. available at <http://www.abanet.org/buslaw/newsletter/0043/materials/pp1.pdf> (discussing allocation options).

(n171)Footnote 171. See, e.g., *Federal Ins. Co. v. Kozlowski*, 18 A.D.3d 33, 792 N.Y.S. 2d 397 (N.Y. App. Div. 2004) (holding that although insurer's ultimate liability to Kozlowski, Tyco International Ltd.'s former Chairman and CEO, for defense costs incurred in civil securities action and criminal proceeding was limited to costs incurred in connection with claims covered by D&O insurance policies and did not extend to liabilities excluded under the "personal profits" exclusion, due to the impossibility of making an allocation between covered and non-covered claims, insurer was required to pay all defense costs as they were incurred and then recoup them as appropriate when

Kozlowski's liabilities, if any, were determined); *see also* Carolyn H. Rosenberg, *Insuring Management in Crisis* 22 (Nov. 18, 2005), in *Corporate Board Member 2005 Special Supplement: Boardroom Liabilities--Shielding Directors from Harm*, available at <http://www.abanet.org/buslaw/newsletter/0043/materials/pp1.pdf> (stating that, absent policy language on allocation of defense costs, "most of the case law" directs that defense expenses reasonably related to a covered claim be apportioned wholly to the claim); Howard B. Epstein & Theodore A. Keyes, *Directors' and Officers' Insurance: Allocation of Defense Costs*, N.Y. L. J. 1 (Aug. 24, 2004); Mark E. Miller, *Top Ten D&O Coverage Issues*, *The Corporate Board* 12, 15 (Nov./Dec. 2004) (discussing defense allocation provisions).

(n172)Footnote 172. *Perdue Farms, Incorporated v. Travelers Casualty & Surety Company of America*, 448 F.3d 252 (4th Cir. 2006) .

(n173)Footnote 173. *Perdue*, 448 F.3d at 256 .

(n174)Footnote 174. *Perdue*, 448 F.3d at 257 .

(n175)Footnote 175. *Perdue*, 448 F.3d at 263 .

(n176)Footnote 176. *See* discussion in § 5.04[6] above.

(n177)Footnote 177. *See, e.g.*, Stephen J. Weiss, *Due Diligence on D&O*, 28 *Directors and Boards* 3 (Spring 2004) (stating that, despite the time and expense necessary for a professional to conduct a thorough analysis of a company's D&O insurance policy, a growing number of prospective directors are requesting this type of analysis from companies before joining their boards); *see also*, Towers Perrin, *Directors and Officers Liability, 2007 Survey of Insurance Purchasing and Claims Trends* 27, available at http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf (noting that survey participants across the board reported making more changes to their D&O coverage based on requests by directors and officers).

(n178)Footnote 178. *See, e.g.*, Russ Banham, *Let's Face It, One Is Never Enough*, *Treasury & Risk* (Nov. 2004), available at <http://www.treasuryandrisk.com/issues/2004/November%202004/Pages/Lets-Face-It-One-Is-Never-Enough.aspx> (citing a "colossal increase" in the purchase of Side A D&O insurance and citing data from a survey of buying trends at Fortune 100 companies showing that 55% to 60% are purchasing supplemental Side A coverage); Fred T. Podolsky & Susanne Murray, Hilb Rogal & Hobbs, *2005 Directors and Officers Liability Snapshot and Insurance Market Forecast* 14, available at <http://www.directorsandboards.com/DBEBRIEFING/JANUARY2005/DO2005FORECAST.PDF> (noting the "increasing tendency to purchase, maintain or expand Side A coverage for directors and officers" and stating that purchase of this coverage is expected "to accelerate in 2005 as more independent directors and audit committees scrutinize coverage that is being purchased").

(n179)Footnote 179. *See* § 5.01 above.

(n180)Footnote 180. *See, e.g.*, Priya Cherian Huskins, *Why are you buying Side A D&O Insurance?*, 2 *International Journal of Disclosure and Governance*, No. 2, at 203 (Mar. 31, 2005).

(n181)Footnote 181. *See, e.g.*, Stephen J. Weiss, *The Rodney Dangerfield of D&O Policies*, 28 *Directors and Boards* 2 (Winter 2004) (discussing the importance of scrutinizing excess policy coverage carefully because terms and conditions may differ from those in the primary policy).

(n182)Footnote 182. *XL Specialty Ins. Co. v. John D. Agoglia et al.*, 2009 U.S. Dist. LEXIS 36601 (S.D.N.Y. Apr. 30, 2009) , discussed in § 5.04[5] above.

(n183)Footnote 183. *See, e.g.*, Stephen J. Weiss & Shannon A.G. Knotts, *Do Independent Directors Need IDL Coverage?*, *Directors and Boards* (May 2005), available at

<http://directorsandboards.com/DBEBRIEFING/May2005/Feature505.html> (noting that officers are more likely than directors to "incur multimillion-dollar defense tabs and settlements," which can erode and possibly exhaust policy limits).

(n184)Footnote 184. See, e.g., Victor F. Mustelier, *Crisis Poses New Risks to Directors*, Directorship (Mar. 19, 2009), available at <http://www.directorship.com/risks-presented-by-the-crisis> (discussing the role of Excess DIC Side A coverage, and its importance given the risk that companies and insurers may become insolvent as a result of the financial crisis); Michael A. Rossi, *Rewriting the Rule Book on D&O Insurance*, XXVII The Risk Report No. 5, at 1, 7-8 (Jan. 2005), available at <http://www.lexis.com> (database: The Risk Report (IRMI)) (outlining key features of a favorably structured Excess DIC Side A policy).

(n185)Footnote 185. See Stephen J. Weiss & Shannon A.G. Knotts, *Do Independent Directors Need IDL Coverage?*, Directors and Boards (May 2005), available at <http://www.hklaw.com/content/whitepapers/idlcoverage.pdf> (stating that IDL has not sold well since it was introduced several years ago, but that this may change); but see Towers Perrin, *Directors and Officers Liability, 2007 Survey of Insurance Purchasing and Claims Trends 22*, available at http://www.towersperrin.com/tp/getwebcachedoc?webc=REIN/USA/2008/200806/do_survey_report_061008.pdf (noting that while most survey participants had not purchased IDL policies, approximately 20% of public companies reported they were considering it).

(n186)Footnote 186. See, e.g., *Outside Director Exposure and the Need for IDL Insurance Protection*, (Oakbridge Insurance Services), May 2007, at 3-4.

(n187)Footnote 187. See, e.g., Russ Banham, *Retired But Not Forgotten*, CFO Magazine, available at <http://www.cfo.com/article.cfm/10910068> (Apr. 1, 2008); Steve Wilson, *Retired Directors Face Continuing Legal Exposures* (2007), available at www.retiredirectors.com/protected/RetiredDirecotrsFacingContinuedLegal+Exposure.pdf.

(n188)Footnote 188. *Allmerica Financial Corp. v. Certain Underwriters at Lloyd's, London*, 871 N.E.2d 418 (Mass. 2007).

(n189)Footnote 189. See *Qualcomm, Inc. v. Certain Underwriters at Lloyds, London*, 161 Cal. App. 4th 184 (2008).

(n190)Footnote 190. *Qualcomm*, 161 Cal. App. 4th at 198.

(n191)Footnote 191. See *Comerica Inc. v. Zurich American Ins. Co.*, 498 F. Supp 2d 1019 (E.D. Mich. 2007). For additional discussion of this issue, see Eric S. Connuck, *Excess D&O Insurance--The Exhaustion by Payment Condition*, Business Law Today (Sept./Oct. 2008).

(n192)Footnote 192. National Association of Corporate Directors, NACD Public Company Governance Survey 52 (2008).



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Appendix 5-A Sample Exculpatory Charter Provision for a Delaware Company

1-5-A Corporate Governance: Law and Practice Appendix 5-A.syn

§ 5-A.syn Synopsis to Appendix 5-A: Sample Exculpatory Charter Provision for a Delaware Company

[5-A] Sample Exculpatory Charter Provision for a Delaware Company



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Appendix 5-A Sample Exculpatory Charter Provision for a Delaware Company

1-5-A Corporate Governance: Law and Practice [5-A]

[5-A] Sample Exculpatory Charter Provision for a Delaware Company

LIABILITY OF DIRECTORS

Section 1 . No Personal Liability. To the fullest extent permitted by the DGCL as the same exists or as may hereafter be amended, no director of the Corporation shall be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.

Section 2 . Amendment or Repeal. Any amendment, alteration or repeal of this Article XI that adversely affects any right of a director shall be prospective only and shall not limit or eliminate any such right with respect to any proceeding involving any occurrence or alleged occurrence of any action or omission to act that took place prior to such amendment or repeal.



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Appendix 5-B Sample Indemnification Bylaw for a Publicly Held Delaware Company

1-5-B Corporate Governance: Law and Practice Appendix 5-B.syn

§ 5-B.syn Synopsis to Appendix 5-B: Sample Indemnification Bylaw for a Publicly Held Delaware Company

[5-B] Sample Indemnification Bylaw for a Publicly Held Delaware Company



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Appendix 5-B Sample Indemnification Bylaw for a Publicly Held Delaware Company

1-5-B Corporate Governance: Law and Practice [5-B]

[5-B] Sample Indemnification Bylaw for a Publicly Held Delaware Company

ARTICLE VI -- INDEMNIFICATION

Section 6.1 Right to Indemnification. Each person who was or is made a party or is threatened to be made a party to or is otherwise involved in any action, suit, arbitration, alternative dispute mechanism, inquiry, administrative or legislative hearing, investigation or any other actual, threatened or completed proceeding, including any and all appeals, whether civil, criminal, administrative or investigative (hereinafter a "proceeding"), by reason of the fact that he or she is or was a director or an officer of the Corporation or while a director or officer of the Corporation is or was serving at the request of the Corporation as a director, officer, employee, agent or trustee of another corporation or of a partnership, joint venture, trust or other enterprise, including service with respect to an employee benefit plan (hereinafter an "indemnitee"), whether the basis of such proceeding is alleged action in an official capacity as a director, officer, employee, agent or trustee or in any other capacity while serving as a director, officer, employee, agent or trustee, shall be indemnified and held harmless by the Corporation to the fullest extent authorized by the DGCL, as the same exists or may hereafter be amended, against all expense, liability and loss (including attorneys' fees, judgments, fines, ERISA excise taxes or penalties and amounts paid in settlement) reasonably incurred or suffered by such indemnitee in connection therewith; provided, however, that, except as provided in Section 6.3 with respect to proceedings to enforce rights to indemnification, the Corporation shall indemnify any such indemnitee in connection with a proceeding (or part thereof) initiated by such indemnitee only if such proceeding (or part thereof) was authorized or ratified by the Board of Directors of the Corporation.

Section 6.2 Right to Advancement of Expenses. In addition to the right to indemnification conferred in Section 6.1, an indemnitee shall, to the fullest extent not prohibited by law, also have the right to be paid by the Corporation the expenses (including attorneys' fees) incurred in defending any such proceeding in advance of its final disposition (hereinafter an "advancement of expenses"); provided, however, that, if the DGCL requires, an advancement of expenses incurred by an indemnitee in his or her capacity as a director or officer (and not in any other capacity in which service was or is rendered by such indemnitee, including, without limitation, service to an employee benefit plan) shall be made only upon delivery to the Corporation of an undertaking (hereinafter an "undertaking"), by or on behalf of such indemnitee, to repay all amounts so advanced if it shall ultimately be determined by final judicial decision from which there is no further right to appeal (hereinafter a "final adjudication") that such indemnitee is not entitled to be

indemnified for such expenses under this Section 6.2 or otherwise.

Section 6.3 Right of Indemnitee to Bring Suit. If a claim under Section 6.1 or 6.2 of this Article VI is not paid in full by the Corporation within 60 days after a written claim has been received by the Corporation, except in the case of a claim for an advancement of expenses, in which case the applicable period shall be 20 days, the indemnitee may at any time thereafter bring suit against the Corporation in a court of competent jurisdiction in the State of Delaware to recover the unpaid amount of the claim. If successful in whole or in part in any such suit, or in a suit brought by the Corporation to recover an advancement of expenses pursuant to the terms of an undertaking, the indemnitee shall be entitled to be paid also the expense of prosecuting or defending such suit. In (a) any suit brought by the indemnitee to enforce a right to indemnification hereunder (but not in a suit brought by the indemnitee to enforce a right to an advancement of expenses) it shall be a defense that, and (b) any suit brought by the Corporation to recover an advancement of expenses pursuant to the terms of an undertaking, the Corporation shall be entitled to recover such expenses upon a final adjudication that, the indemnitee has not met any applicable standard for indemnification set forth in the DGCL. Neither the failure of the Corporation (including its directors who are not parties to such action, a committee of such directors, independent legal counsel, or its stockholders) to have made a determination prior to the commencement of such suit that indemnification of the indemnitee is proper in the circumstances because the indemnitee has met the applicable standard of conduct set forth in the DGCL, nor an actual determination by the Corporation (including its directors who are not parties to such action, a committee of such directors, independent legal counsel, or its stockholders) that the indemnitee has not met such applicable standard of conduct, shall create a presumption that the indemnitee has not met the applicable standard of conduct or, in the case of such a suit brought by the indemnitee, be a defense to such suit. In any suit brought by the indemnitee to enforce a right to indemnification or to an advancement of expenses hereunder, or brought by the Corporation to recover an advancement of expenses pursuant to the terms of an undertaking, the burden of proving that the indemnitee is not entitled to be indemnified, or to such advancement of expenses, under this Article VI or otherwise shall be on the Corporation.

Section 6.4 Non-Exclusivity of Rights. The rights to indemnification and to the advancement of expenses conferred in this Article VI shall not be exclusive of any other right which any person may have or hereafter acquire under any law, agreement, vote of stockholders or directors, provisions of the Certificate of Incorporation or these Bylaws or otherwise.

Section 6.5 Insurance. The Corporation may maintain insurance, at its expense, to protect itself and any director, officer, employee or agent of the Corporation or another corporation, partnership, joint venture, trust or other enterprise against any expense, liability or loss, whether or not the Corporation would have the power to indemnify such person against such expense, liability or loss under the DGCL.

Section 6.6 Indemnification of Employees and Agents of the Corporation. The Corporation may, to the extent authorized from time to time by the Board of Directors, grant rights to indemnification and to the advancement of expenses to any employee or agent of the Corporation to the fullest extent of the provisions of this Article VI with respect to the indemnification and advancement of expenses of directors and officers of the Corporation.

Section 6.7 Nature of Rights. The rights conferred upon indemnitees in this Article VI shall be contract rights and such rights shall continue as to an indemnitee who has ceased to be a director, officer or trustee and shall inure to the benefit of the indemnitee's heirs, executors and administrators. Any amendment, alteration or repeal of this Article VI that adversely affects any right of an indemnitee or its successors shall be prospective only and shall not limit or eliminate any such right with respect to any proceeding involving any occurrence or alleged occurrence of any action or omission to act that took place prior to such amendment, alteration or repeal.

Section 6.8 Settlement of Claims. The Corporation shall not be liable to indemnify any indemnitee under this Article VI for any amounts paid in settlement of any action or claim effected without the Corporation's written consent, which

consent shall not be unreasonably withheld, or for any judicial award if the Corporation was not given a reasonable and timely opportunity, at its expense, to participate in the defense of such action.

Section 6.9 Subrogation. In the event of payment under this Article VI, the Corporation shall be subrogated to the extent of such payment to all of the rights of recovery of the indemnitee, who shall execute all papers required and shall do everything that may be necessary to secure such rights, including the execution of such documents necessary to enable the Corporation effectively to bring suit to enforce such rights.

Section 6.10 Procedures for Submission of Claims. The Board of Directors may establish reasonable procedures for the submission of claims for indemnification pursuant to this Article VI, determination of the entitlement of any person thereto and review of any such determination.



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Appendix 5-C Sample Director and Officer Indemnification Agreement for a Delaware Company

1-5-C Corporate Governance: Law and Practice Appendix 5-C.syn

§ 5-C.syn Synopsis to Appendix 5-C: Sample Director and Officer Indemnification Agreement for a Delaware Company

[5-C] Sample Director and Officer Indemnification Agreement for a Delaware Company



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Appendix 5-C Sample Director and Officer Indemnification Agreement for a Delaware Company

1-5-C Corporate Governance: Law and Practice [5-C]

[5-C] Sample Director and Officer Indemnification Agreement for a Delaware Company

INDEMNIFICATION AGREEMENT

dated as of _____, 200____ between _____ Company (the "Company"), and _____ ("Indemnitee")

WHEREAS, the Board of Directors has determined that the inability to attract and retain qualified persons as directors and officers is detrimental to the best interests of the Company's stockholders and that the Company should act to assure such persons that there shall be adequate certainty of protection through insurance and indemnification against risks of claims and actions against them arising out of their service to and activities on behalf of the Company; and

WHEREAS, the Company has adopted provisions in its [**Certificate of Incorporation**] [**and**] [**By-laws**] providing for indemnification and advancement of expenses of its directors and officers to the fullest extent permitted by the Delaware General Corporation Law, and the Company wishes to clarify and enhance the rights and obligations of the Company and Indemnitee with respect to indemnification and advancement of expenses; and

WHEREAS, in order to induce and encourage highly experienced and capable persons such as Indemnitee to serve and continue to serve as directors and officers of the Company and in any other capacity with respect to the Company, and to otherwise promote the desirable end that such persons shall resist what they consider unjustified lawsuits and claims made against them in connection with the good faith performance of their duties to the Company, with the knowledge that certain costs, judgments, penalties, fines, liabilities and expenses incurred by them in their defense of such litigation are to be borne by the Company and they shall receive the maximum protection against such risks and liabilities as may be afforded by law, the Board of Directors of the Company has determined that the following Agreement is reasonable and prudent to promote and ensure the best interests of the Company and its stockholders; and

WHEREAS, the Company desires to have Indemnitee continue to serve as a director or officer of the Company and in such other capacity with respect to the Company as the Company may request, as the case may be, free from undue concern for unpredictable, inappropriate or unreasonable legal risks and personal liabilities by reason of Indemnitee acting in good faith in the performance of Indemnitee's duty to the Company; and Indemnitee desires to continue so to

serve the Company, provided, and on the express condition, that he or she is furnished with the indemnity set forth hereinafter;

Now, therefore, in consideration of Indemnitee's continued service as a director or officer of the Company, the parties hereto agree as follows:

1. **Service by Indemnitee.** Indemnitee shall serve and/or continue to serve as a director or officer of the Company faithfully and to the best of Indemnitee's ability so long as Indemnitee is duly elected or appointed and until such time as Indemnitee is removed as permitted by law or tenders a resignation in writing.

2. **Indemnification and Advancement of Expenses.** The Company shall indemnify Indemnitee, and shall pay to Indemnitee in advance of the final disposition of any Proceeding all Expenses incurred by Indemnitee, to the fullest extent permitted by the Delaware General Corporation Law in effect on the date of this Agreement or as such law may from time to time be amended (but, in the case of any such amendment, only to the extent that such amendment permits the Company to provide broader rights than said law permitted the Company to provide prior to such amendment). Without diminishing the scope of the rights provided by this Section, the rights of Indemnitee to indemnification and advancement of Expenses provided hereunder shall include but shall not be limited to those rights hereinafter set forth, except that no indemnification or advancement of Expenses shall be paid to Indemnitee:

(a) to the extent expressly prohibited by Delaware law or the **[Certificate of Incorporation] [and] [By-laws]** of the Company;

(b) for which payment is actually made to Indemnitee under a valid and collectible insurance policy or under a valid and enforceable indemnity clause, provision of the certificate of incorporation or by-laws, or agreement of the Company or any other company or organization where Indemnitee is serving at the request of the Company, except in respect of any indemnity exceeding the payment under such insurance, indemnity clause, provision of the certificate of incorporation or by-laws, or agreement;
[or]

(c) in connection with an action, suit or proceeding, or part thereof (including claims and counterclaims) initiated by Indemnitee, except a judicial proceeding or arbitration pursuant to Section 10 to enforce rights under this Agreement, unless the action, suit or proceeding (or part thereof) was authorized by the Board of Directors of the Company;
[or]

(d) with respect to any Proceeding brought by or on behalf of the Company against Indemnitee that is authorized by the Board of Directors of the Company, except as provided in Sections 4, 5 and 6 *below*.n1

3. **Action or Proceedings Other than an Action by or in the Right of the Company.** Except as limited by Section 2 above, Indemnitee shall be entitled to the indemnification rights provided in this Section if Indemnitee is a party or is threatened to be made a party to any Proceeding (other than an action by or in the name of the Company) by reason of the fact that Indemnitee is or was a director, officer, employee, agent or fiduciary of the Company, or is or was serving at the request of the Company as a director, officer, employee, agent or fiduciary of any other entity (including, but not limited to, another corporation, partnership, joint venture or trust); or by reason of anything done or not done by Indemnitee in any such capacity. Pursuant to this Section, Indemnitee shall be indemnified against all costs,

judgments, penalties, fines, liabilities, amounts paid in settlement and Expenses, actually and reasonably incurred by Indemnitee in connection with such Proceeding, if Indemnitee acted in good faith and in a manner Indemnitee reasonably believed to be in or not opposed to the best interests of the Company, and with respect to any criminal Proceeding, had no reasonable cause to believe his or her conduct was unlawful.

4. Indemnity in Proceedings by or in the Name of the Company. Except as limited by Section 2 *above*, Indemnitee shall be entitled to the indemnification rights provided in this Section if Indemnitee was or is a party or is threatened to be made a party to any Proceeding brought by or in the name of the Company to procure a judgment in its favor by reason of the fact that Indemnitee is or was a director, officer, employee, agent or fiduciary of the Company, or is or was serving at the request of the Company as a director, officer, employee, agent or fiduciary of any other entity (including, but not limited to, another corporation, partnership, joint venture or trust); or by reason of anything done or not done by Indemnitee in any such capacity. Pursuant to this Section, Indemnitee shall be indemnified against all costs, judgments, penalties, fines, liabilities, amounts paid in settlement and Expenses, actually and reasonably incurred by Indemnitee in connection with such Proceeding if Indemnitee acted in good faith and in a manner Indemnitee reasonably believed to be in or not opposed to the best interests of the Company; provided, however, that no such indemnification shall be made in respect of any claim, issue, or matter as to which Delaware law expressly prohibits such indemnification by reason of any adjudication of liability of Indemnitee to the Company, unless and only to the extent that the Court of Chancery of the State of Delaware or the court in which such Proceeding was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, Indemnitee is entitled to indemnification for such costs, judgments, penalties, fines, liabilities, amounts paid in settlement and Expenses as such court shall deem proper.

5. Indemnification for Costs, Charges and Expenses of Successful Party. Notwithstanding the limitations of Section [2(d)],n2 3 and 4 *above*, to the extent that Indemnitee has been successful, on the merits or otherwise, in whole or in part, in defense of any Proceeding or in defense of any claim, issue or matter therein, including, without limitation, the dismissal of any action without prejudice, or if it is ultimately determined, after all appeals by a court of competent jurisdiction, that Indemnitee is otherwise entitled to be indemnified against Expenses, Indemnitee shall be indemnified against all Expenses actually and reasonably incurred in connection therewith.

6. Partial Indemnification. If Indemnitee is entitled under any provision of this Agreement to indemnification by the Company for some or a portion of the costs, judgments, penalties, fines, liabilities, amounts paid in settlement or Expenses, actually and reasonably incurred in connection with any Proceeding, or in connection with any judicial proceeding or arbitration pursuant to Section 10 to enforce rights under this Agreement, but not, however, for all of the total amount thereof, the Company shall nevertheless indemnify Indemnitee for the portion of such costs, judgments, penalties, fines, liabilities, amounts paid in settlement and Expenses, actually and reasonably incurred to which Indemnitee is entitled.

[7. Indemnification for Expenses of a Witness. Notwithstanding any other provision of this Agreement, to the maximum extent permitted by the Delaware General Corporation Law, Indemnitee shall be entitled to indemnification against all Expenses actually and reasonably incurred or suffered by Indemnitee or on Indemnitee's behalf if Indemnitee appears as a witness or otherwise incurs legal expenses as a result of or related to Indemnitee's service as a director or officer of the Company, in any threatened, pending or completed action, suit or proceeding, whether of a civil, criminal, administrative,

investigative, legislative or other nature, to which Indemnitee neither is, nor is threatened to be made, a party.

8. **Determination of Entitlement to Indemnification.** To receive indemnification under this Agreement, Indemnitee shall submit a written request to [the Secretary of] the Company. Such request shall include documentation or information which is necessary for such determination and which is reasonably available to Indemnitee. Upon written request by Indemnitee for indemnification pursuant to Sections 3, 4, 5, 6 or [7] the entitlement of Indemnitee to indemnification, to the extent not provided pursuant to the terms of this Agreement, shall be determined by the following person or persons who shall be empowered to make such determination: (a) the Board of Directors of the Company by a majority vote of Disinterested Directors, whether or not such majority constitutes a quorum; (b) a committee of Disinterested Directors designated by a majority vote of such directors, whether or not such majority constitutes a quorum; (c) if there are no Disinterested Directors, or if the Disinterested Directors so direct, by Independent Counsel in a written opinion to the Board of Directors, a copy of which shall be delivered to Indemnitee; (d) the stockholders of the Company; or (e) in the event that a Change in Control has occurred, by Independent Counsel in a written opinion to the Board of Directors, a copy of which shall be delivered to Indemnitee. Such Independent Counsel shall be selected by the Board of Directors and approved by Indemnitee, except that in the event that a Change in Control has occurred, Independent Counsel shall be selected by Indemnitee. Upon failure of the Board so to select such Independent Counsel or upon failure of Indemnitee so to approve (or so to select, in the event that a Change in Control has occurred), such Independent Counsel shall be selected upon application to a court of competent jurisdiction. The determination of entitlement to indemnification shall be made not later than 30 calendar days after receipt by the Company of a written request for indemnification. Any amounts incurred by Indemnitee in connection with a request for indemnification or payment of Expenses hereunder, under any other agreement, any provision of the Company's [**Certificate of Incorporation**] [**and**] [**By-laws**] or any directors' and officers' liability insurance, shall be borne by the Company. The Company hereby indemnifies Indemnitee for any such amounts and agrees to hold Indemnitee harmless therefrom irrespective of the outcome of the determination of Indemnitee's entitlement to indemnification. If the person making such determination shall determine that Indemnitee is entitled to indemnification as to part (but not all) of the application for indemnification, such person shall reasonably prorate such partial indemnification among the claims, issues or matters at issue at the time of the determination.

9. **Presumptions and Effect of Certain Proceedings.** The Secretary of the Company shall, promptly upon receipt of Indemnitee's written request for indemnification, advise in writing the Board of Directors or such other person or persons empowered to make the determination as provided in Section 8 that Indemnitee has made such request for indemnification. Upon making such request for indemnification, Indemnitee shall be presumed to be entitled to indemnification hereunder and the Company shall have the burden of proof in making any determination contrary to such presumption. If the person or persons so empowered to make such determination shall have failed to make the requested determination with respect to indemnification within 30 calendar days after receipt by the Company of such request, a requisite determination of entitlement to indemnification shall be deemed to have been made and Indemnitee shall be absolutely entitled to such indemnification, absent actual and material fraud in the request for indemnification. The termination of any Proceeding described in Sections 3 or 4 by judgment, order, settlement or conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself: (a) create a presumption that Indemnitee did not act in good faith and in a manner which Indemnitee reasonably believed to be in or not opposed to the best interests of the Company, or, with respect to any criminal Proceeding, that Indemnitee had reasonable cause to believe that Indemnitee's conduct was unlawful; or (b) otherwise adversely affect the rights of Indemnitee to indemnification except as may be provided herein.

10. Remedies of Indemnitee in Cases of Determination not to Indemnify or to Advance Expenses. In the event that a determination is made that Indemnitee is not entitled to indemnification hereunder or if payment has not been timely made following a determination of entitlement to indemnification pursuant to Sections 8 and 9, or if Expenses are not paid pursuant to Section 15, Indemnitee shall be entitled to final adjudication in a court of competent jurisdiction of entitlement to such indemnification or payment. Alternatively, Indemnitee at Indemnitee's option may seek an award in an arbitration to be conducted by a single arbitrator pursuant to the rules of the American Arbitration Association, such award to be made within 60 calendar days following the filing of the demand for arbitration. The Company shall not oppose Indemnitee's right to seek any such adjudication or award in arbitration or any other claim. The determination in any such judicial proceeding or arbitration shall be made *de novo* and Indemnitee shall not be prejudiced by reason of a determination (if so made) pursuant to Sections 8 or 9 that Indemnitee is not entitled to indemnification. If a determination is made or deemed to have been made pursuant to the terms of Section 8 or 9 that Indemnitee is entitled to indemnification, the Company shall be bound by such determination and is precluded from asserting that such determination has not been made or that the procedure by which such determination was made is not valid, binding and enforceable. The Company further agrees to stipulate in any such court or before any such arbitrator that the Company is bound by all the provisions of this Agreement and is precluded from making any assertions to the contrary. If the court or arbitrator shall determine that Indemnitee is entitled to any indemnification or payment of Expenses hereunder, the Company shall pay all Expenses actually and reasonably incurred by Indemnitee in connection with such adjudication or award in arbitration (including, but not limited to, any appellate proceedings).

11. Other Rights to Indemnification. Indemnification and payment of Expenses provided by this Agreement shall not be deemed exclusive of any other rights to which Indemnitee may now or in the future be entitled under any provision of the Certificate of Incorporation or By-laws of the Company, vote of stockholders or Disinterested Directors, provision of law, agreement or otherwise.

12. Expenses to Enforce Agreement. In the event that Indemnitee is subject to or intervenes in any action, suit or proceeding in which the validity or enforceability of this Agreement is at issue or seeks an adjudication or award in arbitration to enforce Indemnitee's rights under, or to recover damages for breach of, this Agreement, Indemnitee, if Indemnitee prevails in whole or in part in such action, suit or proceeding, shall be entitled to recover from the Company and shall be indemnified by the Company against any Expenses actually and reasonably incurred by Indemnitee.

13. Continuation of Indemnity. All agreements and obligations of the Company contained herein shall continue during the period Indemnitee is a director, officer, employee, agent or fiduciary of the Company or is serving at the request of the Company as a director, officer, employee, agent or fiduciary of any other entity (including, but not limited to, another corporation, partnership, joint venture or trust) and shall continue thereafter with respect to any possible claims based on the fact that Indemnitee was a director, officer, employee, agent or fiduciary of the Company or was serving at the request of the Company as a director, officer, employee, agent or fiduciary of any other entity (including, but not limited to, another corporation, partnership, joint venture or trust). This Agreement shall be binding upon all successors and assigns of the Company (including any transferee of all or substantially all of its assets and any successor by merger or operation of law) and shall inure to the benefit of the heirs, personal representatives and estate of Indemnitee.

14. Notification and Defense of Claim. Promptly after receipt by Indemnitee of notice of any Proceeding, Indemnitee shall, if a claim in respect thereof is to be made against the Company under this Agreement, notify the Company in writing of the commencement thereof; but the omission so to notify

the Company shall not relieve it from any liability that it may have to Indemnitee. Notwithstanding any other provision of this Agreement, with respect to any such Proceeding of which Indemnitee notifies the Company:

(a) The Company shall be entitled to participate therein at its own expense; and

(b) Except as otherwise provided in this Section 14(b), to the extent that it may wish, the Company, jointly with any other indemnifying party similarly notified, shall be entitled to assume the defense thereof, with counsel satisfactory to Indemnitee. After notice from the Company to Indemnitee of its election so to assume the defense thereof, the Company shall not be liable to Indemnitee under this Agreement for any expenses of counsel subsequently incurred by Indemnitee in connection with the defense thereof except as otherwise provided below. Indemnitee shall have the right to employ Indemnitee's own counsel in such Proceeding, but the fees and expenses of such counsel incurred after notice from the Company of its assumption of the defense thereof shall be at the expense of Indemnitee unless (i) the employment of counsel by Indemnitee has been authorized by the Company, (ii) Indemnitee shall have reasonably concluded that there may be a conflict of interest between the Company and Indemnitee in the conduct of the defense of such Proceeding, or (iii) the Company shall not within 60 calendar days of receipt of notice from Indemnitee in fact have employed counsel to assume the defense of the Proceeding, in each of which cases the fees and expenses of Indemnitee's counsel shall be at the expense of the Company. The Company shall not be entitled to assume the defense of any Proceeding brought by or on behalf of the Company or as to which Indemnitee shall have made the conclusion provided for in (ii) above; and

(c) If the Company has assumed the defense of a Proceeding, the Company shall not be liable to indemnify Indemnitee under this Agreement for any amounts paid in settlement of any Proceeding effected without the Company's written consent. The Company shall not settle any Proceeding in any manner that would impose any penalty or limitation on or disclosure obligation with respect to Indemnitee without Indemnitee's written consent. Neither the Company nor Indemnitee shall unreasonably withhold its consent to any proposed settlement.

15. **Advancement of Expenses.** All Expenses incurred by Indemnitee in advance of the final disposition of any Proceeding shall be paid by the Company at the request of Indemnitee. To receive payment of Expenses under this Agreement, Indemnitee shall submit a written request to [the Secretary of] the Company. Such request shall reasonably evidence the Expenses incurred by Indemnitee and shall include or be accompanied by an undertaking, by or on behalf of Indemnitee, to reimburse such amounts if it is ultimately determined, after all appeals by a court of competent jurisdiction, that Indemnitee is not entitled to be indemnified against such Expenses by the Company as provided by this Agreement or otherwise. Indemnitee's undertaking to reimburse any such amounts is not required to be secured. Each such payment of Expenses shall be made within 20 calendar days after the receipt by the Company of such written request. Indemnitee's entitlement to such Expenses shall include those incurred in connection with any action, suit or proceeding by Indemnitee seeking a judgment in court or an adjudication or award in arbitration pursuant to Section 10 of this Agreement (including the enforcement of this provision) to the extent the court or arbitrator shall determine that Indemnitee is entitled to payment of Expenses hereunder.

16. **Separability; Prior Indemnification Agreements.** If any provision or provisions of this Agreement shall be held to be invalid, illegal or unenforceable for any reason whatsoever (a) the validity, legality

and enforceability of the remaining provisions of this Agreement (including without limitation, all portions of any paragraphs of this Agreement containing any such provision held to be invalid, illegal or unenforceable, that are not by themselves invalid, illegal or unenforceable) shall not in any way be affected or impaired thereby, and (b) to the fullest extent possible, the provisions of this Agreement (including, without limitation, all portions of any paragraph of this Agreement containing any such provision held to be invalid, illegal or unenforceable, that are not themselves invalid, illegal or unenforceable) shall be construed so as to give effect to the intent of the parties that the Company provide protection to Indemnitee to the fullest enforceable extent. This Agreement shall supersede and replace any prior indemnification agreements entered into by and between the Company and Indemnitee and any such prior agreements shall be terminated upon execution of this Agreement.

17. **Headings; References; Pronouns.** The headings of the sections of this Agreement are inserted for convenience only and shall not be deemed to constitute part of this Agreement or to affect the construction thereof. References herein to section numbers are to sections of this Agreement. All pronouns and any variations thereof shall be deemed to refer to the masculine, feminine, neuter, singular or plural as appropriate.

18. **Definitions.** For purposes of this Agreement:

(a) "Change in Control" means a change in control of the Company occurring after the date of this Agreement of a nature that would be required to be reported in response to Item 5.01 of Current Report on Form 8-K (or in response to any similar item on any similar schedule or form) promulgated under the Securities Exchange Act of 1934, whether or not the Company is then subject to such reporting requirement; provided, however, that, without limitation, a Change of Control shall be deemed to have occurred if after the date of this Agreement (i) any "person" (as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934) becomes the "beneficial owner" (as defined in Rule 13d-3 under the Securities Exchange Act of 1934), directly or indirectly, of securities of the Company representing [30%] or more of the combined voting power of the Company's then outstanding securities without the prior approval of at least two-thirds of the members of the Board of Directors in office immediately prior to such person attaining such percentage, (ii) the Company is a party to a merger, consolidation, sale of assets or other reorganization, or a proxy contest, as a consequence of which members of the Board of Directors in office immediately prior to such transaction or event constitute less than a majority of the Board of Directors thereafter, or (iii) during any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors (including for this purpose any new director whose election or nomination for election by the Company's stockholders was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of such period) cease for any reason to constitute at least a majority of the Board of Directors.

(b) "Disinterested Director" means a director of the Company who is not or was not a party to the Proceeding in respect of which indemnification is being sought by Indemnitee.

(c) "Expenses" includes, without limitation, expenses incurred in connection with the defense or settlement of any investigation, action, suit or other proceeding, including any judicial, administrative, investigative, legislative or other proceedings, and appeals, attorneys' fees, witness fees and expenses, fees and expenses of accountants and other

advisors, retainers and disbursements and advances thereon, the premium, security for, and other costs relating to any bond (including cost bonds, appraisal bonds or their equivalents), and any expenses of establishing a right to indemnification or advancement under Sections 8, 10, 12 and 15 above but shall not include the amount of judgments, penalties, fines or amounts paid in settlement.

(d) "Independent Counsel" means a law firm or a member of a law firm that neither is presently nor in the past five years has been retained to represent: (i) the Company or Indemnitee in any matter material to either such party, or (ii) any other party to the Proceeding giving rise to a claim for indemnification hereunder. Notwithstanding the foregoing, the term "Independent Counsel" shall not include any person who, under the applicable standards of professional conduct then prevailing, would have a conflict of interest in representing either the Company or Indemnitee in an action to determine Indemnitee's right to indemnification under this Agreement.

(e) "Proceeding" includes any threatened, pending or completed investigation, action, suit or other proceeding, whether brought in the name of the Company or otherwise, against Indemnitee, whether of a civil, criminal, administrative, investigative, legislative or other nature, including, but not limited to, actions, suits or proceedings in which Indemnitee may be or may have been involved as a party or otherwise, by reason of the fact that Indemnitee is or was a director, officer, employee, agent or fiduciary of the Company, or is or was serving, at the request of the Company, as a director, officer, employee, agent or fiduciary of any other entity, including, but not limited to, another corporation, partnership, joint venture or trust, or by reason of anything done or not done by Indemnitee in any such capacity, whether or not Indemnitee is serving in such capacity at the time any liability or expense is incurred for which indemnification or reimbursement can be provided under this Agreement.

19. Other Provisions.

(a) This Agreement shall be interpreted and enforced in accordance with the laws of Delaware.

(b) This Agreement may be executed in one or more counterparts, each of which shall for all purposes be deemed to be an original but all of which together shall constitute one and the same Agreement. Only one such counterpart signed by the party against whom enforceability is sought needs to be produced as evidence of the existence of this Agreement.

(c) This Agreement shall not be deemed an employment contract between the Company and any Indemnitee who is an officer of the Company, and, if Indemnitee is an officer of the Company, Indemnitee specifically acknowledges that Indemnitee may be discharged at any time for any reason, with or without cause, and with or without severance compensation, except as may be otherwise provided in a separate written contract between Indemnitee and the Company.

(d) Upon a payment to Indemnitee under this Agreement, the Company shall be subrogated to the extent of such payment to all of the rights of Indemnitee to recover against any person for such liability, and Indemnitee shall execute all documents and instruments required and shall take such other actions as may be necessary to secure such

rights, including the execution of such documents as may be necessary for the Company to bring suit to enforce such rights.

(e) No supplement, modification or amendment of this Agreement shall be binding unless executed in writing by both parties hereto. No waiver of any of the provisions of this Agreement shall be deemed or shall constitute a waiver of any other provisions hereof (whether or not similar) nor shall such waiver constitute a continuing waiver.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on and as of the day and year first above written.

The Company

By _____

Indemnitee

FOOTNOTES:

(n2)Footnote 1. This is a fairly common limitation on indemnification and advancement rights and could be included here to the extent a company has such a limitation in its charter or bylaws.

(n3)Footnote 2. To be included if the limitation in Section 2(d) *above* is included.

(n4)Footnote 3. This provision is optional. In weighing whether to include it, a company should consider that covering expenses of directors and officers who serve as witnesses in actions to which they are not a party could result in substantial costs for the company.

(n5)Footnote 4. To be included if the company includes the witness provision in Section 7 *above*.



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Corporate Governance: Law and Practice

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CHAPTER 6 CORPORATE GOVERNANCE GUIDELINES FOR BOARD PRACTICES AND PROCEDURES

1-6 Corporate Governance: Law and Practice 6.syn

AUTHOR: Holly J. Gregory

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§ 6.04 Creating and Disclosing Corporate Governance Guidelines

Holly J. Gregory n*

FOOTNOTES:

(n1)Footnote *. Holly J. Gregory, a partner with the international law firm of Weil, Gotshal & Manges LLP, practices in the firm's corporate governance group. The author would like to thank Bethany J. Cooper, for her assistance.



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CHAPTER 6 CORPORATE GOVERNANCE GUIDELINES FOR BOARD PRACTICES AND PROCEDURES

1-6 Corporate Governance: Law and Practice § 6.01

AUTHOR: Holly J. Gregory

§ 6.01 Corporate Governance Guidelines: Introduction

To achieve the accountability that is the foundation of good corporate governance, the board must consider and maintain a consistent approach to monitoring and guiding the corporation's affairs. Formalizing board policies and procedures through the articulation of a set of corporate governance guidelines helps the board formulate its ideas about how it will govern and assures consistency. Formalized guidelines also provide a useful means for communicating the board's governance approach to shareholders and other interested observers. This chapter discusses elements often addressed in corporate governance guidelines to comport with contemporary views of effective governance practices as well as with recently imposed listing requirements of the New York Stock Exchange ("NYSE").

[1] Corporate Governance Guidelines: Overview

The law holds the board of directors responsible for monitoring management to assure shareholders that corporate assets are being used in the interests of the corporation.ⁿ¹ To meet this responsibility the board must support entrepreneurial risk-taking on the one hand, while holding management accountable on the other. The articulation of clear corporate governance principles assists the board in achieving this balance by:

- Establishing a culture that fosters objective judgment;
- Delineating roles and focusing the board on specific governance tasks;
- Providing a framework for decision-making and crisis response;
- Facilitating effective legal and regulatory compliance;
- Encouraging ongoing evaluation of governance structures and processes; and
- Maintaining governance continuity.

In addition, disclosure of corporate governance principles helps assure investors that the board understands and is

committed to its responsibilities.

Any one of these positive effects ought to cause a board to consider articulating its corporate governance principles in a formal written set of guidelines. In addition, interest in guidelines has been generated by legislative and regulatory activity at the federal level that has raised the bar of acceptable corporate governance practices for public companies.ⁿ² More specifically, in 2003 the NYSE adopted new listing standards that, among other things, require domestic listed companies to adopt and disclose a set of "corporate governance guidelines."ⁿ³

[2] Codes of Best Practice

Interest in the role of the board and, in particular, the role of independent directors began to accelerate in the 1970s, when a series of corporate failures and scandals at a number of U.S. corporations led to passage of the Foreign Corrupt Practices Act of 1977 and the adoption by the NYSE of audit committee requirements.ⁿ⁴ As this interest grew throughout the past decade and a half, a number of legal, management, director and investor organizations articulated ideas about governance "best practice," often in published statements generically described as "codes of best practice." The American Law Institute, the Business Roundtable, the National Association of Corporate Directors ("NACD"), the Conference Board, and the Business Law Section of the American Bar Association have published recommendations on improving practices and procedures in corporate governance that, to varying extents, provide the basis for increasing a board's ability and motivation to monitor managerial performance.ⁿ⁵ These codes of best practice focus on how to ensure that the board is positioned as an entity separate and distinct from corporate management to bring informed and objective judgment to its decision-making. Codes of best practice have long expressed consensus as to the importance of director independence and, specifically, the need for non-management directors to control the audit, compensation, and nominating functions, the performance evaluation of the CEO and the determination of the board's own governance processes.

The "soft regulation" provided by these codes of best practice is in keeping with the regulatory philosophy that "one size does not fit all" when it comes to board practices. By definition, codes of best practice provide standards to aspire to. This does not mean that these codes of best practice lack force and effect. Even though compliance with substantive code provisions is wholly voluntary, reputation and market forces have focused corporate and investor attention on governance issues and have provided compliance pressures.ⁿ⁶ Over time, recommended best practices have often become the norm and in many instances the basis for minimum standards, as, for example, reflected in the amendments to the listing rules of the NYSE and The NASDAQ Stock Market ("NASDAQ").ⁿ⁷ They may also influence judicial expectations about board behavior.ⁿ⁸

The structure and practice of corporate boards of directors has been a particular focus of institutional activism in recent years. Coincident with their growing dominance as shareholders of publicly traded corporations, institutional investors have become active in corporate governance reform efforts. Increased sophistication about the use of shareholder power--and limits on their ability to sell the stock of underperforming portfolio companies--has focused key institutional investors on improving the accountability of corporate boards and managers. In recent years, two of the most influential institutional investors, the California Public Employees' Retirement System ("CalPERS") the largest U.S. public pension fund, with more than U.S. \$200 billion in assets under management) and the Teachers Insurance and Annuity Association-College Retirement Equities Fund ("TIAA-CREF"), a private pension fund that is the largest U.S. pension fund, public or private, with assets of more than U.S. \$370 billion under management, have issued guideline documents that express their expectations about how the board of directors carries out its functions.ⁿ⁹ Also in recent years, the Council of Institutional Investors ("CII") (representing over 140 pension fund members with more than U.S. \$3 trillion in assets under management) and the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") (representing over 9 million persons organized in labor unions) have issued guidelines relating to the corporate governance practices of the board.ⁿ¹⁰ In emphasizing the need for directors to exert independent influence over management while abjuring a "one-size-fits-all" approach, these documents tend to express philosophies similar to the board best practice suggestions issued by the NACD, the Business Roundtable and others.

Nonetheless, some differences remain on topics such as who should qualify as an "independent director," and whether and to what extent independent board leadership is called for.

[3] The Corporate Governance Guideline Movement

In early 1994, the General Motors board of directors issued a set of corporate governance guidelines it had designed after a management crisis. The guidelines set forth procedures and structures the board designed to assist it in active and independent monitoring of management performance.¹¹ Key provisions included:¹²

- Independent leadership in the form of either a separate independent chairman or a lead independent director;
- "Executive sessions" of the independent directors without management present at least two or three times per year to discuss management performance and to evaluate the chief executive officer ("CEO");
- CEO evaluation based on objective criteria, including the performance of the business and accomplishment of its strategic objectives;
- Annual board self-evaluation;
- Independent director control (through a committee) over board governance processes;
- Separate chairman or lead director input into setting the board agenda and determining the board's information needs (together with the CEO), with additional input from board members;
- Concise information on agenda items circulated in advance, with board meeting time reserved for discussion;
- Independent director control of the selection of board candidates (with input from the CEO); and
- Invitations to join the board extended by the board itself.

GM's efforts caught the attention of CalPERS, who asked the 300 largest public companies in its portfolio if they had adopted similar guidelines and then graded and published the responses. The "grades" ranged from "A+" to "F," based on whether, and to what degree, the response indicated board involvement in developing an independent monitoring relationship between the board and management, and whether that relationship was formally established in a set of guidelines. The considerable publicity generated by CalPERS caused a number of boards to adopt and publish guidelines and generally spurred interest in governance practices among the investor community.¹³

By 2003, just prior to adoption of the NYSE's requirement that domestic listed companies adopt and disclose guidelines, the adoption of corporate governance guidelines had become a common practice among large Fortune 1000 companies listed on the NYSE and NASDAQ.¹⁴

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityLimitationsBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawSelf-Regulating EntitiesNational Association of Securities DealersSecurities LawSelf-Regulating EntitiesNational Securities

ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* Delaware General Corporation Law ("DGCL") § 141(a) (*Del. Code Ann. tit. 8, § 141(a)*) (revised 1974)) [hereinafter DGCL § 141]. Directors owe fiduciary duties to the corporation and its common shareholders. *Reylon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (*Del. 1985*) ; *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377 (*Del. Ch. 1999*) .

The inherent tension between managerial and shareholder interests forms the central problem of corporate governance. As observed by Adam Smith in 1776 and Berle and Means in 1932, the human tendency to benefit oneself, which is at the heart of economic activity, may result in managerial self-dealing, entrenchment, or the inefficient use of corporate assets. Adam Smith, *An Inquiry Into The Nature and Cause of the Wealth of Nations*, Vol. II, 264-65 (Edwin Canaan edition, 1776); Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* 123 (1932). *See also* Ira Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 *Colum. L. Rev.* 1283, 1292 (1998) ("[T]he board is the agent for shareholders and monitors management to assure that managerial decisions are in the best interests of shareholders.").

(n2)Footnote 2. *See generally* the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), 15 U.S.C. §§ 78, 7201 *et seq.* (2003), and related Securities and Exchange Commission ("SEC") rules.

(n3)Footnote 3. Under revisions to the NYSE listing rules approved by the SEC on November 4, 2003 and amendments approved by the SEC on November 3, 2004, domestic listed companies are required to adopt and disclose a set of corporate governance guidelines. NYSE Listed Company Manual § 303A.09. Commentary to § 303A.09 provides that each company's website must include its guidelines and its key committee charters, and that the company's annual report on Form 10-K filed with the SEC "must state that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it." Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those required of domestic companies. NYSE Listed Company Manual § 303A.11. The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

The corporate governance listing standards of The NASDAQ Stock Market ("NASDAQ") do not require that domestic listed companies adopt and disclose a set of corporate governance guidelines. However, a number of NASDAQ companies do so as a matter of best practice. *See, e.g.*, Korn/Ferry Int'l, 31st Annual Board of Directors Study 33 (2004) [hereinafter "2004 Korn/Ferry Study"] (96 percent of respondents report that their boards have adopted written corporate governance guidelines-up from 71 percent in 2002).

(n4)Footnote 4. Ira M. Millstein & Paul W. MacAvoy, *The Recurrent Crises in Corporate Governance* (Chapter 3) 20-22 (2003) (citations omitted):

In the early 1970s, the SEC launched an investigation of Penn Central Railroad: 'the Enron failure of its day.' The SEC criticized the Penn Central board for failing to oversee the company's operations, for lacking independence from management, and for being unable to identify the company's financial problems.

Following the Penn Central investigation, the SEC began to focus on financial reporting and board oversight of management in a number of other corporations. While the link between Penn Central and SEC focus on audit procedures was not totally clear in its enforcement actions, the SEC in general began to require that boards form committees, composed wholly of independent directors, designed to monitor compliance with SEC regulations on financial reporting. Then, in 1977, the SEC approved a New York Stock Exchange rule requiring all listed US companies to form audit committees comprised of a majority of independent directors. The new listing rule marked the beginning of the emergence of independent

directors as a key component of governance change.

The board's responsibilities gained further attention in the mid-1980s when the surge in corporate takeover activity, and related court actions, led the SEC to require boards to pursue the interests of investors seeking to sell their shares to acquiring firms when management resisted a takeover. The SEC made board positions contestable when it revised the proxy rules for voting shares in annual board elections to allow shareholders to join together and publicize their voting positions against a management initiative. With increasing sophistication in the use of shareholder power-and recognition of their limited ability to sell the stock of under-performing portfolio companies-key institutional investors began to work to improve the accountability of corporate managers.

Finally, the decision by the General Motors (GM) board to publish 'governance guidelines' after it had discharged a non-performing CEO-and the decision by CalPERS to ask its portfolio companies whether they had considered adopting guidelines similar to the GM guidelines-brought the issue of governance and corporate performance to the attention of all large US corporations.

See Foreign Corrupt Practices Act of 1977, 15 U.S.C.A. §§ 78a-78ff (1977, as amended). In 1977, the SEC approved a NYSE listing rule requiring that each listed company have an audit committee in place as of June 30, 1978. NYSE Listed Company Manual § 901.01, II, 7 ("The Corporation will maintain an audit committee in conformity with Exchange requirements (effective 6-30-78)").

(n5)Footnote 5. American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Vol. 1, §§ 1.01-6.02 (May 1992, published 1994 and regularly supplemented) [hereinafter ALI Principles of Corporate Governance]; the Business Roundtable, the Role and Composition of Directors of The Large-Publicly Owned Corporation (Jan. 1978); Business Roundtable, Corporate Governance and American Competitiveness (Mar. 1990); Business Roundtable, Statement on Corporate Governance (Sept. 1997); Business Roundtable, Principles of Corporate Governance (May 2002), as revised in Nov. 2005 [hereinafter Business Roundtable Principles], reproduced in Appendix A to this treatise; NACD, Report of The Blue Ribbon Commission on Performance Evaluation of Chief, Executive Officers, Boards and Directors (1994) [hereinafter NACD Report on Performance Evaluation]; NACD, Report of The Blue Ribbon Commission on Director Compensation (1995 updated in 2001); NACD, Report of The Blue Ribbon Commission on Director Professionalism (1996, reissued 2005) [hereinafter NACD Report on Director Professionalism]; The Conference Board, Corporate Boards: Improving and Evaluating Performance (1994); The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1: Executive Compensation (Sept. 2002), and Findings and Recommendations, Part 2: Corporate Governance & Part 3: Audit And Accounting (Jan. 2003); American Bar Association Committee on Corporate Laws, Corporate Director's Guidebook (5th ed. 2007) [hereinafter ABA Corporate Director's Guidebook]; NACD, Report of the Blue Ribbon Commission on Director Liability: Myths, Realities, and Prevention (2006) [hereinafter the NACD Report on Director Liability].

(n6)Footnote 6. Issues that institutional shareholders have focused on in recent years include: improving the quality of executive compensation disclosures (details regarding pay for performance; dates of stock option grants; and a company's relationship with a compensation consultant); providing shareholders with access to proxy statements; implementing majority voting standards (discussed in more detail in *Section 6.03[4]*) and declassified boards; requiring policies designed to recoup compensation awarded to executives during periods of fraud or a restatement of financial statements; eliminating supermajority voting requirements for actions such as amending a company's corporate documents; and requiring shareholder approval for a variety of corporate actions (such as approval to renew or adopt shareholder rights plans).

(n7)Footnote 7. On November 4, 2003 the SEC approved the corporate governance standards filed by the NYSE and NASDAQ. *See* SEC Release No. 34-48745 (Nov. 4, 2003). On November 3, 2004 the SEC approved amendments

to the NYSE corporate governance standards. *See* SEC Release No. 34-50625 (Nov. 3, 2004). The entire NYSE Listed Company Manual § 303A is reproduced in Appendix B to this treatise. Note that on November 23, 2005, the NYSE filed with the SEC proposed rule changes to Section 303A of the NYSE Listed Company Manual concerning the standards for determining director independence and related disclosure requirements (File No. SR-NYSE-2005-81). Partly in response to the amendments made by the SEC to its director independence disclosure requirements in August 2006 (*i.e.*, new Item 407 of Regulation S-K) on June 20, 2007 the NYSE filed with the SEC an amendment to its proposed changes (File No. SR-NYSE-2005-81 Amendment No. 2). On July 28, 2006, Nasdaq filed with the SEC proposed amendments relating to the definition of "independent director." (Rel. No. 34-54333; SEC File No. SR-NASDAQ-2006-021). The SEC approved these amendments on October 6, 2006 (Rel. No. 34-54583, File No. SR-NASDAQ-2006-021). On October 3, 2006 Nasdaq filed with the SEC proposed rule changes to Nasdaq's definition of "independent director" (File No. SR-NASDAQ-2006-041) and on March 2, 2007 filed Amendment No. 1 to the proposed rule change which would increase the "bright line" test with respect to a director's receipt of compensation from the issuer from \$60,000 to \$100,000. On March 13, 2007 the SEC granted approval to this rule change on an accelerated basis (Release No. 34-55463, File No. SR-NASDAQ-041).

(n8)Footnote 8. *See* discussion at § 6.02[1] below.

(n9)Footnote 9. California Public Employees' Retirement System ("CalPERS"), U.S. Corporate Governance-Core Principles and Guidelines (Apr. 1998 updated March 2006) [hereinafter CalPERS Core Principles and Guidelines]; Teachers Insurance and Annuity Association-College Retirement Equities Fund ("TIAA-CREF"), Policy Statement on Corporate Governance (Oct. 1997, revised Jan. 2004, March 2007) [hereinafter TIAA-CREF Policy Statement].

(n10)Footnote 10. Council of Institutional Investors, Corporate Governance Policies (Mar. 1998, most recently revised April 2006) [hereinafter CII Policies]; American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), Exercising Authority, Restoring Accountability--AFL-CIO Proxy Voting Guidelines (1997, revised 2003) [hereinafter AFL-CIO Proxy Voting Guidelines].

(n11)Footnote 11. *See* Robert L. Simison, *GM Board Adopts Formal Guidelines on Stronger Control Over Management*, Wall St. J., Mar. 28, 1994, at A4.

(n12)Footnote 12. General Motors Board of Directors, Corporate Governance Guidelines on Significant Corporate Governance Issues [hereinafter GM Corporate Governance Guidelines] (1994, most recently revised May 2007) *available at* www.gm.com/company/investor_information/corp_gov/guidelines.html. The GM Corporate Governance Guidelines adopted in 1994 were consistent with principles of board governance advocated by a coalition of lawyers for large public companies and leading institutional investors:

- The board of directors should evaluate the performance of the CEO regularly against established goals and strategies.
- This evaluation should be performed by "outside" directors.
- All outside directors should meet alone, at least once a year, coordinated by a leader.
- Directors should establish appropriate qualifications for board members and communicate those qualifications clearly to shareholders.
- Outside directors should screen and recommend candidates based on qualifications established by the board.

July-Aug. 1991, at 141-143.

(n13)Footnote 13. The corporate governance practices of public company boards are highly scrutinized by large institutional shareholders such as CalPERS, TIAA-CREF and the AFL-CIO, as well as by shareholder groups such as CII, and proxy voting advisers like Institutional Shareholder Services, Inc. ("ISS"). Ratings services (ISS, GovernanceMetrics International ("GMI"), Standard & Poor's and Moody's Investors Service) are also focusing on governance practices and, as a result, a board's ability to demonstrate and communicate a commitment to good governance practices has become an important aspect of investor relations. "Governance experts say the rating agencies are beginning to address the fact that issues such as lazy boards of directors, dominant chief executives or bloated pay structures can threaten companies' success--and investor wealth--as seriously as excess debt or flawed business plans." Ben White, *Bond-Rating Firms Get Into Governance; Analysts Assess Corporate Practices*, Wash. Post, Feb.15, 2003, at E01. ISS has developed a Corporate Governance Quotient ("CGQ") which uses 61 criteria sorted into eight core categories (including board structure, audit, charter and bylaw provisions, laws of the state of incorporation, executive and director compensation, qualitative factors, D&O stock ownership, and director education) to evaluate corporate governance issues. ISS Corporate Governance Quotient *available at* www.isscgq.com/abouttheratings.htm. GMI takes into account many of the same criteria as ISS, but weights more than 600 variables, including environmental and workplace safety and earnings management. Phyllis Plitch, *Corporate Governance Gets a Rating*, Wall St. J., Feb. 26, 2003, at B6G; *See* The GMI Rating Process: Information for Rated Companies *available at* [www.gmiratings.com/\(u12xt5yhgi345rjo5lvfp545\)/Default.aspx](http://www.gmiratings.com/(u12xt5yhgi345rjo5lvfp545)/Default.aspx). Standard & Poor's launched its governance-rating service in 1998. For a fee, "domestic companies can hire S&P to come in and perform an extensive review of their corporate governance practices, from director independence to executive pay and benefits, to shareholders rights and takeover defense mechanisms." Ben White, *Bond-Rating Firms Get Into Governance; Analysts Assess Corporate Practices*, Wash. Post, Feb. 15, 2003, at E01; *See* Standard & Poor's Corporate Governance Services *available at* www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_product/ProductBodyTemplate&c=sp_product&cid=1021984025974&t

(n14)Footnote 14. *See, e.g.*, 2004 Korn/Ferry Study 33.



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Corporate Governance: Law and Practice

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CHAPTER 6 CORPORATE GOVERNANCE GUIDELINES FOR BOARD PRACTICES AND PROCEDURES

1-6 Corporate Governance: Law and Practice § 6.02

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§ 6.02 Corporate Governance Guideline Elements Required by the NYSE

Section 303A.09 of the NYSE Listed Company Manual provides that: "Listed companies must adopt and disclose corporate governance guidelines."ⁿ¹ The commentary to Section 303A.09 notes that no single set of guidelines would be appropriate for every company.ⁿ² Various factors unique to a company (including, among others, size, organizational structure, line of business and applicable requirements of local, regional or national law) may affect the provisions that should be addressed. However, there are certain elements which must be addressed.ⁿ³ This section discusses the elements required by the NYSE to be addressed in published guidelines, together with clearly related topics.

Note that corporate governance guidelines are generally meant to serve as a practical tool, within the larger framework of laws and regulations that define the board's role and its obligations. Some companies' guidelines include language to indicate that they are not intended, and should not be read, to place additional legal obligations on the board.ⁿ⁴

[1] Director Responsibilities

Corporate governance guidelines commonly begin with a recitation of the board's responsibilities, often including statements about the corporate objective, accountability to shareholders, relationships with employees, customers, suppliers and the broader community, and director duties of care, loyalty and good faith.ⁿ⁵

The NYSE Listed Company Manual requires that listed companies address the topic of director responsibilities in their corporate governance guidelines in a manner that "clearly articulate[s] what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials."ⁿ⁶

Directors' responsibilities fall into two major categories:

- *Decision Making on Key Matters.* Generally, the board decides what operations the corporation will pursue, its long term business plans, which officers will run the corporation, where and how they will run the business and how the corporation will organize itself to benefit the shareholders.ⁿ⁷ Generally, directors have the ultimate responsibility for the management of the enterprise and they typically satisfy

their obligations by appointing qualified, professional managers, establishing or approving goals and plans and monitoring performance.

■ *Oversight.* Directors have a duty to oversee the management of the corporation. This requires that they monitor the performance of the officers of the corporation in managing the corporation's business and affairs. However, directors may rely in good faith upon information provided by the officers.⁸ Directors also have a duty to create reporting systems designed to discourage and detect the fraudulent, illegal or criminal activities of subordinates.⁹

By articulating board responsibilities, guidelines remind directors of the stewardship they have undertaken. Specific board duties typically addressed throughout guidelines include:¹⁰

- Approving a corporate philosophy and mission;
- Selecting, monitoring, evaluating, choosing goals for, compensating and--if necessary--replacing the CEO and in some circumstances, other principal senior executives;
- Reviewing and approving management's strategic and business plans and monitoring corporate performance against the strategic and business plans to evaluate whether the business is being properly managed;
- Reviewing and approving the corporation's financial objectives and major corporate plans and actions;
- Reviewing and approving material transactions not in the ordinary course of business;
- Reviewing and approving major changes in the auditing and accounting principles and practices to be used in preparing the corporation's financial statements;
- Providing oversight of risk assessment, internal controls and processes designed to promote legal and ethical compliance and monitoring compliance with those policies;
- Articulating expectations and standards related to corporate culture and the "tone at the top";
- Understanding the corporation's financial statements and monitoring the adequacy of its financial and other internal controls, as well as its disclosure controls and procedures;
- Developing and implementing succession plans for the CEO;
- Reviewing the process for providing adequate and timely financial and operational information to management, directors and shareholders;
- Establishing the composition of the board and its committees and determining governance practices;
- Retaining independent advisors in performance of committee duties and decision-making;
- Assessing the effectiveness of the board and its committees; and
- Performing any other functions prescribed by law.

Guidelines may list additional activities related to the firm's specific business operations, but further elaboration as to board tasks is relatively uncommon, and usually reserved to committee charters.

Guidelines sometimes also address the care, loyalty and good faith required of directors by addressing expectations concerning regular meeting attendance, time commitment, preparation, the need to be inquisitive and seek out information, as well as the need to avoid and disclose conflicts, hold information confidentially and handle corporate opportunities appropriately.

[2] Director Qualification Standards

The NYSE Listed Company Manual requires that corporate guidelines address director qualification standards, and, at minimum, reflect the independence requirements set forth in NYSE rules.ⁿ¹¹ The NYSE also advises that guidelines may address other director qualification standards, including limits on the number of boards a director may serve and director tenure, retirement and succession.ⁿ¹²

[a] General Qualification Criteria

A company's board may choose to address qualification criteria generally in its corporate governance guidelines or may give more expansive treatment to the subject of director qualifications. In either event, the task of developing specific requirements for board qualifications usually rests with an independent nominating/corporate governance committee.ⁿ¹³ While recognizing that suitable qualifications depend on the unique circumstances and business considerations affecting the company, the NACD suggests that qualifications include personal characteristics such as integrity, accountability, judgment, confidence, high performance standards and financial literacy.ⁿ¹⁴ In addition, qualifications should provide for an adequate mix of core competencies on the board in areas of accounting and finance, business judgment, management, crisis response, industry knowledge, international markets, leadership and strategic vision.ⁿ¹⁵ The NACD advises that boards should select individuals on the basis of their commitment to learn the business of the company, meet any stock ownership requirements and devote the requisite time and attention.ⁿ¹⁶ The NACD also advocates that consideration be given to (i) the ability to "approach others assertively, responsibly and supportively;" and (ii) the "willingness to raise tough questions in a manner that encourages open discussion."ⁿ¹⁷ It suggests that a director's suitability be re-evaluated whenever he or she resigns from or changes employment.ⁿ¹⁸

The CalPERS Core Principles and Guidelines similarly recommend that a board evaluate each nominee on the basis of his or her ability to contribute to the mix of characteristics, experience, diverse perspectives and skills most appropriate for the company.ⁿ¹⁹ Some guidelines note that the corporation's need for particular backgrounds and experiences may change over time, and the board (or the nominating committee) monitors the mix of skills and experience that directors bring to the board, to ensure that the board has the necessary tools to perform its oversight function effectively.ⁿ²⁰

[b] Independence

Both the NYSE listing rules and the NASDAQ listing rules generally require listed company boards to be comprised of a majority of independent directors and require disclosures relating to how the board meets this requirement.ⁿ²¹ Many companies impose standards that go beyond the minimum requirements, for example, by requiring that a "substantial majority" of directors be independent.ⁿ²²

Under NYSE rules, companies must identify which directors are independent and disclose the basis for that determination.ⁿ²³ To qualify as independent the board of directors must affirmatively determine that the director has no "material relationships" with the company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company.ⁿ²⁴ Material relationships may include "commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships among others."ⁿ²⁵ The basis for determining that a

relationship is not material must be disclosed in the company's annual proxy statement to shareholders.ⁿ²⁶ The board can satisfy this requirement by adopting and disclosing categorical standards for qualifying as independent and then disclosing whether an individual director meets the standard.ⁿ²⁷ Corporate governance guidelines can provide the form for adopting and disclosing these categorical standards.

Under NYSE rules, directors having any of the following relationships within the last three yearsⁿ²⁸ are not eligible to be considered independent:ⁿ²⁹

- A director who is, or has been within the last three years, an employee, or whose immediate family member is, or has been within the last three years, an executive officer, of the company;
- A director who receives, or whose immediate family member receives, during any twelve-month period within the last three years, direct compensation of more than \$100,000 per year from the company, not including director compensation or pension or deferred compensation for prior service (provided that such compensation is not contingent in any way on continued service);ⁿ³⁰
- (A) a director who is, or whose immediate family member is, a current partner of the company's auditor; (B) a director who is a current employee of the company's auditor; (C) any immediate family member of the director who is a current employee of the company's auditor and who participates in the auditor's audit, assurance or tax compliance (but not tax planning) practice; or (D) a director who was, or whose immediate family was, within the last three years (but is no longer) a partner or employee of the company's auditor who personally worked on the company's audit within that time frame;
- A director who is, or has been within the last three years, or whose immediate family member is, or has been within the last three years, an executive officer of another company upon whose compensation committee any of the listed company's current executives serve; and
- A director who is a current employee, or whose immediate family member is a current executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2 percent of such other company's consolidated gross revenues.ⁿ³¹

Under NASDAQ rules an independent director is a director who, in the opinion of the board, lacks relationships that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.ⁿ³² Under NASDAQ rules, directors having any of the following relationships cannot be considered independent:ⁿ³³

- A director who is, or within the past three years was, an employee or officer of the company or any of its affiliates;
- A director who is a family member of an individual who is, or within the past three years was, employed by the corporation or any of its affiliates as an executive officer;
- A director who is, or within the past three years was (or has a family member who is or was), compensatedⁿ³⁴ by the company or any of its affiliates in excess of \$100,000ⁿ³⁵ per annum, not including compensation for board service, benefits under a qualified retirement plan, non-discretionary compensation, or compensation paid to a family member who is an employee (other than an executive officer) of the company or its affiliates;
- A person who is, or whose family member is, a partner in, or controlling shareholder or executive officer of, an organization (including non-profits) to which the company made, or from which the

company received, payments that exceeded 5 percent of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, in any of the past three years (excluding payments arising solely from investments in the company's securities or payments under non-discretionary charitable contribution matching programs);

- A person who is, or whose family member is, employed as an executive officer of another entity where at any time during the past three years any of the company's executive officers serve on that entity's compensation committee; or
- A person who is, or whose family member is, a current partner of the company's outside auditor or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.ⁿ³⁶

The contemporary push for independent boards is based on the following goals and assumptions:

The independence of directors must be *de facto* as well as *de jure*. In practical terms, independence may be considered as: the ability to think independently; the ability to consider board matters with objectivity, impartiality, fairness and flexibility; the exercise of independent judgment about management's actions and competence; the courage to challenge management's current or projected future actions—and vote against them when this is warranted; the commitment to review and discuss all proposals of importance, and a governance environment that encourages directors to voice their opinions without the fear that they will incur the wrath or ridicule of other board members or management.ⁿ³⁷

Since it is impossible to set standards that will guarantee the kind of objectivity and independent thought described, an absence of the kind of relationships that may result in conflicted interests is used as a surrogate.

In adopting categorical independence standards for disclosure,ⁿ³⁸ more than the per se prohibitions provided by applicable listing rules should be described. For example, in determining the independence of directors, some boards set more rigorous financial thresholds than listing rules require and/or describe certain charitable relationships that would impair a director's independence.ⁿ³⁹

[c] Limits to Service on Other Boards

Board service requires a significant commitment of time and energy.ⁿ⁴⁰ Therefore, some boards adopt guidelines limiting the number of public company boards and, in some instances non-profit boards, on which a director may sit.ⁿ⁴¹ In addition to setting numerical limits, guidelines may require directors to notify the board, the board chairman or the chairman of the nominating/corporate governance committee prior to accepting an invitation to serve on another board. For example, the NACD recommends that, subject to individual exceptions, the numbers of positions on other boards be limited to one or two for CEOs and other senior executives, three or four for other fully employed directors, and five or six for all other directors.ⁿ⁴²

[d] Term and Age Limits

Boards often adopt guidelines that limit the number of terms a director may serve or set an age limit for directors.ⁿ⁴³ Term and age limits are useful methods for ensuring that new perspectives and energy are periodically introduced into the board dynamic.ⁿ⁴⁴ However, the efficacy of such policies should be balanced by a need for board continuity and institutional history.ⁿ⁴⁵

[e] Changes in Position

Over the past decade, boards have increasingly adopted guidelines that provide that upon a change in a director's

professional responsibilities (such as retirement, resignation or change in employer), such director notify the board and even tender his or her resignation to the board. Such a requirement acknowledges that the other positions a director holds often are a consideration in the nominating decision. Additionally, a notification requirement that includes tender of resignation helps send the signal that continued board service is not automatic. It also helps avoid placing the board in the potentially awkward situation of having to ask such a director for his or her resignation. Usually, the requirement is tempered by a provision that, upon receiving the resignation, the board shall determine whether such change in status will impact that person's ability to fulfill his or her directorship obligation and, accordingly, accept or reject the director's resignation.ⁿ⁴⁶

[f] Board Committees

Board committees provide an important means for organizing the considerable work of the board in an efficient manner.ⁿ⁴⁷ Federal law and listing rules, and codes of best practice have highlighted the importance of committee independence for the three key board committees--audit, compensation, and nominating/governance--and the need for relevant expertise.ⁿ⁴⁸ Corporate governance guidelines often state that the board has delegated certain tasks to a committee, and may also provide that the board relies on the diligence and recommendations of board committees in its deliberations. In recognition of the prominent role board committees play, corporate governance guidelines often include provisions regarding appropriate qualifications and independence criteria for committee members.ⁿ⁴⁹

The Sarbanes-Oxley Act and related SEC rules require that every member of an audit committee be "independent."ⁿ⁵⁰ Additionally, the NYSE and NASDAQ have adopted listing standards regarding the requirements of audit committee members.ⁿ⁵¹ Both the NYSE and NASDAQ require that audit committee members meet the independence requirements of the Sarbanes-Oxley Act and the SEC implementing rules;ⁿ⁵² NASDAQ rules also require that an audit committee member must not have participated in the preparation of the financial statements of the company or any current subsidiary at any time during the past three years.ⁿ⁵³ Additionally, a public company must disclose in its annual report to the SEC or in its annual proxy statement whether at least one member of the audit committee qualifies as a "financial expert."ⁿ⁵⁴ NYSE and NASDAQ rules have additional financial literacy and financial expertise requirements.ⁿ⁵⁵

[3] Director Access to Management, Independent Advisers and Information

Generally, directors may reasonably rely upon, and delegate board functions to, board committees, corporate officers and independent advisors, provided the decision to delegate is an informed one.ⁿ⁵⁶ For example, Delaware General Corporation Law § 141(e) permits the board to rely in good faith on officers, employees, committees of the board of directors or competent outside advisors, provided that due care is exercised in selecting those upon whom reliance is placed.ⁿ⁵⁷ In doing so, the board "is entitled to the presumption that it exercised proper business judgment, including proper reliance on the expert."ⁿ⁵⁸ Directors may not, however, blindly rely on even a carefully selected and qualified expert.ⁿ⁵⁹

The NYSE Listed Company Manual requires that guidelines address directors' access to management and, as necessary, independent advisors.ⁿ⁶⁰ Corporate governance guidelines should facilitate the ability of the board, committees and individual directors to interact with senior managers, while encouraging the use of good judgment to ensure that such contact is not distracting to the operation of the company. Guidelines often welcome the regular attendance of senior managers at board meetings,ⁿ⁶¹ both for their insights into items being discussed, but also as a means of understanding the "bench strength" of the organization for purposes of management development and succession planning.

Other resources crucial to effective decision-making are access to legal counsel, experts and independent advisors. For example, NYSE rules require that the audit committee have the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties, with appropriate funding--as determined by the audit committee--from the company for payment of compensation to any outside legal, accounting or other advisors

employed by the audit committee.ⁿ⁶² The NYSE rules also state that the compensation committee charter should give that committee sole authority to retain and terminate compensation consultants assisting in the evaluation of director, CEO or senior executive compensation, including sole authority to approve the firm's fees and other retention terms.ⁿ⁶³ Similarly, the charter of the nominating/corporate governance committee should give that committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.ⁿ⁶⁴ Board guidelines often provide that committees may retain and obtain advice from such resources on an ongoing basis, free of influence from management, and that committees may rely on these resources when presented with complex and technical matters in which members lack knowledge or expertise.ⁿ⁶⁵

[4] Board Agenda and Information

[a] Board Agenda

It is common for corporate governance guidelines to address issues related to the setting of meeting agendas. Guidelines often address who participates in agenda settingⁿ⁶⁶ (e.g., "The Chairman of the Board, with input from senior members of management and directors, establishes the agenda for each board meeting."). It is also common for guidelines to provide that the agenda will circulate in advance,ⁿ⁶⁷ and that the schedule of agenda subjects to be discussed for the ensuing year is issued at the beginning of each year (to the degree that these can be foreseen).ⁿ⁶⁸ The role of the lead or presiding director in helping to determine appropriate agenda issues with the Chairman/CEO (when those roles are combined) may also be specified.ⁿ⁶⁹

[b] Materials and Information

Corporate governance guidelines often address expectations about the timing, delivery and quality of information distributed to directors. A board lacking appropriate and timely information related to company performance, the environment in which it operates and material issues facing the company may be compromised in its ability to make informed and objective decisions.ⁿ⁷⁰ This, in turn, may make directors vulnerable in lawsuits relating to their conduct. "[I]f directors are fully informed and are diligent prior to making a decision, their decision will be given great deference--especially if the board is composed of a majority of outside directors."ⁿ⁷¹

Corporate governance guidelines often note that information and data that is important to the board's understanding of business and agenda items should be distributed in writing to the board in advance of the board meeting (to the extent possible).ⁿ⁷² The provisions related to advance distribution should not be unduly strict, however, and should allow for unusual circumstances. An advance notice requirement should not serve to prevent information (or an issue) from coming before the board.

The quality of the information available to directors impacts their decision-making capacity. Information made available to directors should be "(i) timely and relevant, (ii) concise and accurate, (iii) well organized, (iv) supported by any background or historical data necessary to place the information in context and (v) designed to inform directors of material aspects of the corporation's business, performance and prospects."ⁿ⁷³ Information important to directors' ability to evaluate corporate performance should provide an understanding of:ⁿ⁷⁴

- The corporation's business or operations;
- The principal operational, financial and other plans, strategies and objectives of the corporation;
- The economic and competitive risks to which the corporation is subject;
- The ongoing financial condition of the corporation;

- The performance of the corporation's significant business segments; and
- The corporation's performance compared with that of its competitors.

[5] Director Compensation

Director compensation policies commonly are designed to align the interests of shareholders and directors and compensate directors for the significant time commitments they are expected to devote to the board. Appropriate compensation may also facilitate recruitment of outside directors. Director compensation is largely self-determined, and therefore the safeguards that transparency provides are important. The NYSE Listed Company Manual states:

Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.ⁿ⁷⁵

A 1995 report issued by the NACD describes principles and procedures for boards to consider in implementing or revising director compensation policies:ⁿ⁷⁶

- Director compensation should be determined by the board and fully disclosed to shareholders;
- Director compensation should be aligned with the long-term interests of shareholders;
- Directors should be adequately compensated for their time and effort;
- Compensation should be approached on an overall basis, rather than as an array of separate elements;
- Boards should establish a process by which directors can determine the compensation program in a deliberate and objective way;
- Boards should set a substantial target for stock ownership by each director and a time period during which this target is to be met;
- Boards should define a desirable total value of all forms of director compensation;
- Boards should pay directors solely in the form of equity and cash—with equity representing 50 to 100 percent of the total; dismantle the existing benefit programs and avoid creating new ones;
- Boards should adopt a policy stating that a company should not hire a director or a director's firm to provide professional services to the corporation; and
- Boards should disclose fully in the proxy statement the philosophy and process used in determining director compensation and the value of all elements of compensation.

Although stock ownership by directors is generally viewed to align directors' interests with those of shareholders,ⁿ⁷⁷ recently the use of stock options as a component of director compensation has been called into question,ⁿ⁷⁸ especially

if the options are exercisable within a short periodⁿ⁷⁹ or other option conditions provide undue incentives for directors to support management and continue their position on the board.ⁿ⁸⁰ The stated concern is that "the motivation of directors should be different than those of management. Directors are not strategic partners with management in creating value for shareholders; they are guardians of shareholders' interests."ⁿ⁸¹

[6] Director Orientation and Continuing Education

Increasingly, director orientation and continuing education are considered components of effective board governance.ⁿ⁸² NYSE listed companies must address director orientation and continuing education in their corporate governance guidelines.ⁿ⁸³ Often boards delegate to the nominating/corporate governance committee (or other appropriate board committee) the task of designing an appropriate orientation program for new directors (which often includes distribution of background material, meetings with senior management and visits to company facilities), as well as the task of designing or making available continuing education opportunities for directors.ⁿ⁸⁴ Continuing education programs often rely on both corporate resources (for in-house programs) and programs available from universities and other providers.

Rating agencies have taken note of the importance of director education programs. For example, ISS's Corporate Governance Quotient includes director education among the eight core categories rated and provides a higher rating for companies whose directors have participated in ISS accredited director education programs, including programs offered by the NACD.ⁿ⁸⁵

[7] Management Succession and Development

According to the NYSE Listed Company Manual, corporate governance guidelines must address management succession.ⁿ⁸⁶ "Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO."ⁿ⁸⁷ Companies often delegate the task of reviewing and evaluating the management succession plan to the nominating and governance committee or to the compensation committee.

Succession planning should involve both a plan for who will step in if the CEO leaves suddenly or is incapacitated and a plan for the orderly transfer of leadership at some appropriate future time in the normal course. Both aspects of succession planning require an understanding of the depth and breadth of the potential available talent, both within and outside the company.

Management succession is often a difficult topic for the CEO, who must face his or her own mortality. This natural hesitancy can be overcome by linking succession planning to management development. Management development is closely related to succession planning, since it enables the company to look internally in the first instance for potential succession candidates. Succession planning is assisted when the company is an organization that attracts, and then works to further develop, talent with appropriate leadership and management skills. Addressing these topics in guidelines provides the board an opportunity to consider its approach to this sensitive issue as a policy matter distinct from decisions concerning a particular individual's position.

In any event, succession planning should involve the board and the CEO in a continuous, collaborative and iterative process. The CEO often has the best understanding of the company's leadership needs and the talent within the organization. The board's role is to:ⁿ⁸⁸

- Engage the CEO in the discussion of succession;
- Continually evaluate CEO performance, including the alignment between leadership competency and corporate strategy; and

- Continually review the depth of leadership talent within the management team, including through regular discussion with the CEO of efforts to develop the management team and cultivate the compliment of skills and leadership expertise consistent with future needs.

[8] Annual Performance Evaluations

[a] Board and Committee Evaluations

Board evaluation provides an opportunity to facilitate board cohesiveness and improve performance, while reminding directors of their roles and responsibilities.ⁿ⁸⁹ For the past decade, it has been considered a component of best practice. Self-evaluation helps ensure that board practices that may have originated from habit, best practices theories or obsolete business models or assumptions will be assessed against actual results. Establishing and disclosing that the board has an evaluation process signals the board's commitment to its governance responsibilities to shareholders.ⁿ⁹⁰

The NYSE Listed Company Manual requires that the corporate governance guidelines of listed companies address board evaluations.ⁿ⁹¹ "The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively."ⁿ⁹² In addition, key committee charters must provide for annual evaluations of committee operations.ⁿ⁹³ (NASDAQ listing standards do not require board or committee evaluations, although many NASDAQ listed companies perform such evaluations as a best practice.) There are no specific requirements for the content of these evaluations nor any requirement that such evaluations be written.ⁿ⁹⁴ Topics that are often addressed in evaluations, in addition to compliance with guidelines and committee charters, include the appropriateness, quality of and/or efficiency of practices relating to board agenda and information flow, board size, composition and independence, board accountability, standards of board conduct, relations between directors and between the board and management, board discussions, board committee functions, board materials and governance guidelines.ⁿ⁹⁵

Because evaluation materials may be discoverable in litigation,ⁿ⁹⁶ some boards are opting for paperless facilitated board and committee discussions as the means of evaluation. When written forms are used, they are typically relied on to collect director viewpoints for a report that is given to the board on the results--as an opportunity to engage the full board in a discussion of board performance. A board should consider, as a matter of policy, whether or not to retain the executed forms (and any related reports) once the information is reviewed, and whether or not the final report should be written or oral.ⁿ⁹⁷ Boards often rely on an outside lawyer or other consultant to assist in gathering and digesting viewpoints (whether using forms or interviews) about board performance and facilitating a board discussion.

[b] Individual Director Evaluations

While not required by listing rules, some boards address individual director evaluations in corporate governance guidelines.ⁿ⁹⁸ Formal individual director evaluations have not been as widely adopted as board and committee evaluations, although they are gaining acceptance. Some boards may view such evaluations as potentially divisive or as difficult to perform in a meaningful way. Many boards already incorporate informal evaluations of individual directors in their re-nomination decisions. Often, the process of reviewing directors is left to the nominating/corporate governance committee.ⁿ⁹⁹

Qualities to consider when identifying the substance for director evaluations may include:

[A]ttendance, preparedness, and participation; business sense and experience; decisiveness; skills in motivating others; oral communications and listening skills; awareness of conflicting interests, critical faculty and problem-solving skills; organizational and strategic awareness; judgment, change-orientation; and integrity. The assessment might also consider objective factors such as standards for director "independence"; whether a director serves on too many other boards; term or age limits; and changes in directors' professional status.ⁿ¹⁰⁰

[c] Chief Executive Officer Evaluations

Some governance guidelines address CEO evaluation procedures, although such procedures are often delegated to an independent committee (usually the nominating/corporate governance or compensation committee). Addressing these procedures in guidelines may help establish a clear understanding between the board and the CEO regarding the process. Formal CEO evaluations are an important component of effective governance and should be linked to the process for determining CEO compensation.ⁿ¹⁰¹ If properly conducted, CEO evaluations can:ⁿ¹⁰²

- Facilitate board-CEO communication regarding company and CEO performance expectations;
- Improve communication between the board and the CEO regarding the evaluation of performance;
- Help the CEO identify personal strengths and weaknesses;
- Provide early warning signals of potential problems to the CEO and the board;
- Provide clear guidelines for CEO compensation decisions;
- Help to foster a sense of teamwork between the board and the CEO;
- Increase the likelihood that the board will support the CEO in times of crisis; and
- Provide a clear signal to shareholders and regulators that the board is monitoring and evaluating the actions of the CEO and senior management.

Factors often considered in CEO evaluations include integrity, vision, leadership, ability to meet specific corporate performance objectives, succession planning, shareholder relations, stakeholder relations and CEO-board relations.ⁿ¹⁰³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityLimitationsBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. NYSE Listed Company Manual § 303A.09. The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.09 Commentary.

(n3)Footnote 3. NYSE Listed Company Manual § 303A.09 Commentary.

(n4)Footnote 4. *See e.g.*, Sample Corporate Governance Guidelines attached as Appendix 6-A to this chapter.

(n5)Footnote 5. Delaware law provides that "[t]he business and affairs of every corporation organized ... shall be managed by or under the direction of a board of directors." DGCL § 141. *See also* Model Bus. Corp. Act § 8.01(b) (1984, revised 2002) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors."). The corporate objective is generally

recognized to be "the conduct of business activities with a view to enhancing corporate profit and shareholder gain." ALI Principles of *Corporate Governance* § 2.01(a). See, e.g., *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders."). Directors stand in a fiduciary relationship to the company and its shareholders, and owe duties of care, loyalty and good faith. The duty of care requires that, in managing the corporation's affairs, directors act: (i) in good faith; (ii) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (iii) in a manner the director reasonably believes to be in the best interests of the corporation. See 2 Model Bus. Corp. Act Annotated §§ 8.30(a)-(b) (3d ed. Supp. 1998/99); Dennis J. Block, Nancy E. Barton, Stephen A. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 20-40, 51-82 (5th ed. 1998) [hereinafter BJR]; *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. Ch. 1963); *Broderick v. Horvatt*, 148 Misc. 731, 266 N.Y.S. 341 (1933); 3A Fletcher *Cyclopedia of the Law of Private Corporations* § 1036 (1984 and 1991 Supp.). The duty of loyalty requires directors to take only those actions that are within the best interests of the corporation, rather than in their own interests. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally"); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (Del. 1939); BJR at 263. Engaging in self-dealing, misappropriating corporate assets or opportunities, having conflicts of interest, or otherwise profiting in a transaction that is not substantively or "entirely fair" to the corporation are all considered breaches of the duty of loyalty. *Solash v. Telex Corp.*, CA 9518, 1988 Del. Ch. LEXIS 7 (1988). Good faith "requires an honesty of purpose and eschews a disingenuous mindset of seeming to act for the corporate good, but not caring for the well being of the constituents of the fiduciary." E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics and Federalism*, University of Pennsylvania Symposium on Control Transactions, at 5 (Feb. 8, 2003). See also Millstein & MacAvoy, *The Recurrent Crises in Corporate Governance* (Chapter 7) 107; *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693 at 755 (Del. Ch. Aug 09, 2005) *aff'd* 906 A.2d 27 (Del. Jun 8, 2006) ("[t]he good faith required of a corporate fiduciary includes not simply the duties of care and loyalty ... in the narrow sense ... but all actions required by true faithfulness and devotion to the interests of the corporation and its shareholders." The court identified the following three "most salient" examples of "[a] failure to act in good faith" or "bad faith," all of which include the element of intent: "where the fiduciary *intentionally* acts with a purpose other than that of advancing the best interests of the corporation," "where the fiduciary acts with *intent* to violate applicable positive law," or "where the fiduciary *intentionally* fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." [emphasis added]). "When a court is considering whether directors breached their fiduciary duties, the business judgment rule is the standard of review that most frequently applies. This is not a rule in the usual sense of the term; it is not set forth by regulators. Rather it is a concept that judges articulate and apply to their review of the facts of a case. Applying this rule, a court presumes that when making a business decision, the directors acted in good faith and in the honest belief that their decision was in the corporation's best interest, taking into account appropriate information." NACD Report on Director Liability 10. If a director's decision is irrational or so beyond reason that no responsible director would credit it, then bad faith may be inferred. See E. Norman Veasey, *Delaware Corporation Law Ethics and Federalism*, The Metropolitan Corporate Counsel, at 13 (Nov. 2002). See also Chapter 4 *above*, discussing the legal duties and responsibilities of the board. "If directors act honestly and in the best interests of the corporation and do not consciously disregard their responsibilities or intentionally neglect their duties, they will satisfy their obligations to conduct themselves loyally and in good faith." NACD Report on Director Liability 10.

(n6)Footnote 6. See NYSE Listed Company Manual § 303A.09 Commentary.

(n7)Footnote 7. Franklin Balotti & Jesse Finkelstein, *The Delaware Law of Corporations & Business Organizations* 4-5 (3d ed. 1998) [hereinafter Balotti]; William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* § 1.02 (7th ed. 2003) [hereinafter Knepper & Bailey].

(n8)Footnote 8. Balotti at 4-36; Knepper & Bailey § 3.07.

(n9)Footnote 9. *See, e.g., In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) .

(n10)Footnote 10. *See* ALI Principles of *Corporate Governance* § 3.02; NACD Report on Director Professionalism 1-2; ABA Corporate Director's Guidebook 13.

(n11)Footnote 11. NYSE Listed Company Manual § 303A.09 Commentary. Sections 303A.01 and.02 of the NYSE Listed Company Manual require that listed companies have a majority of independent directors and provide a detailed definition of independence. The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n12)Footnote 12. NYSE Listed Company Manual § 303A.09 Commentary.

(n13)Footnote 13. NYSE listed companies must have an independent nominating/corporate governance committee comprised entirely of independent directors and the committee must have a charter that addresses the committee's purpose. NYSE Listed Company Manual § 303A.04. At a minimum, that purpose must include: (a) identification of qualified board candidates; (b) selection (or recommendation for board selection) of director nominees; (c) development of a set of corporate governance principles applicable to the company; and (d) overseeing the evaluation of the board and management. NYSE Listed Company Manual § 303A.04. NASDAQ listing rules require that director nominees must either be selected (or recommended for the Board's selection) either by a majority of independent directors or a nominating committee comprised solely of independent directors; additionally, boards must adopt a charter or board resolution, as applicable, regarding the nomination process and other such related matters as required by federal securities laws. NASD Rule 4350(c) (NASD Rule 4350 is reproduced in Appendix C to this treatise). *See also* Chapter 8 *below*, discussing the nominating/corporate governance committee.

(n14)Footnote 14. Note that the listing rules of the NYSE and NASDAQ require audit committee members to be financially literate. NYSE Listed Company Manual § 303A.07(a) Commentary; NASD Rule 4350(d). The NACD focuses on financial literacy as an important requirement for all directors, given the need for directors to continually monitor the financial information of the firm; review financial reports and complex business arrangements (such as derivative instruments or off-balance-sheet obligations) with risks in mind; understand and enhance the company's accounting policies; and remain prepared to question and challenge the company's business and financial disclosure. *See* NACD Report on Director Professionalism 9-10; NACD, Report of the NACD Blue Ribbon Commissions on Risk Oversight 23-25 (2002). *See also* Chapter 9 *below*, discussing the audit committee.

(n15)Footnote 15. NACD Report on Director Professionalism 10-11.

(n16)Footnote 16. NACD Report on Director Professionalism 13-15.

(n17)Footnote 17. NACD Report on Director Professionalism 10.

(n18)Footnote 18. NACD Report on Director Professionalism 14.

(n19)Footnote 19. CalPERS Core Principles and Guidelines, Core Principles B.2 & C.2.

(n20)Footnote 20. *See, e.g.,* GM Corporate Governance Guidelines, Guideline 1.

(n21)Footnote 21. NYSE Listed Company Manual § 303A.01 ("Listed companies must have a majority of independent directors."); NASD Rule 4350(c)(1) ("A majority of the board of directors must be comprised of independent directors.").

(n22)Footnote 22. NACD Report on Director Professionalism 11; Business Roundtable Principles 14.

(n23)Footnote 23. NYSE Listed Company Manual § 303A.02(a).

(n24)Footnote 24. NYSE Listed Company Manual § 303A.02(a).

(n25)Footnote 25. NYSE Listed Company Manual § 303A.02(a) Commentary. The commentary to Rule 303A.02(a) states that "when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation."

(n26)Footnote 26. NYSE Listed Company Manual § 303A.02(a) Commentary. If the company does not file an annual proxy statement, the basis for the determination that a relationship is not material must be disclosed in the Company's annual report on Form 10-K filed with the SEC. NYSE Listed Company Manual § 303A.02(a) Commentary.

(n27)Footnote 27. NYSE Listed Company Manual § 303A.02(a) Commentary.

(n28)Footnote 28. A transition rule in effect until November 4, 2004 uses a one-year look back rather than the three year look back. NYSE Listed Company Manual § 303A.02 Transition Rule.

(n29)Footnote 29. NYSE Listed Company Manual § 303A.02(b)(i)-(v).

(n30)Footnote 30. Compensation received (i) for prior service as an interim Chairman, CEO or other executive officer or (ii) by an immediate family member for service as an employee (other than an executive officer) of the listed company is not considered disqualifying for this purpose.

(n31)Footnote 31. The general commentary to NYSE Listed Company Manual § 303A.02(b) notes that an "immediate" family member includes a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. The NYSE has proposed amending the definition of "immediate family member" to clarify that it does not include stepchildren who do not share a stepparent's home, or the in-laws of such stepchildren. *See* SEC File No. SR NYSE-2005-81 (Nov. 23, 2005).

(n32)Footnote 32. NASD Rule 4350(c). According to this rule, the board has an affirmative responsibility to determine that a director does not have a relationship that would interfere with the exercise of independent judgment.

(n33)Footnote 33. NASD Rule 4200(a)(15), reproduced in Appendix C to this treatise.

(n34)Footnote 34. Nasdaq recently amended this provision to substitute "compensation" for "payments." This amendment clarifies that payments for personal services or political contributions to a candidate will be considered disqualifying compensation. *See* SEC File No. SR-NASDAQ-2006-021 (Oct. 6, 2006).

(n35)Footnote 35. On October 3, 2006 Nasdaq filed with the SEC proposed rule changes to Nasdaq's definition of "independent director" (File No. SR-NASDAQ-2006-041) and on March 2, 2007 filed Amendment No. 1 to the proposed rule change which would increase the "bright line" test with respect to a director's receipt of compensation from the issuer from \$60,000 to \$100,000. On March 13, 2007 the SEC granted approval to this rule change on an accelerated basis (Release No. 34-55463, File No. SR-NASDAQ-041).

(n36)Footnote 36. NASD Rule 4200(a)(14). Under this rule, "family member" includes a person's spouse, parents, children, and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.

(n37)Footnote 37. NACD, Report of the NACD Blue Ribbon Commission on Board Evaluations 8 (2001).

(n38)Footnote 38. *See* discussion in this § 6.02[2][b] above .

(n39)Footnote 39. *See, e.g.*, General Electric Company Board of Directors, Governance Principles, Principle 4, *available at* www.ge.com/en/company/governance/govprinc.htm [hereinafter GE Governance Principles] ("A director will not be independent if, at the time of the independent determination, the director serves as an executive officer, director or trustee of a charitable organization, and GE's discretionary charitable contributions to the organization are the greater of \$200,000 or one percent of that organization's annual consolidated gross revenues during its last completed fiscal year. (GE's automatic matching of employee charitable contributions will not be included in the amount of GE's contributions for this purpose.)"); The Disney Company, Corporate Governance Guidelines, Guideline 3 (as amended and restated through October 1, 2007) *available at* <http://corporate.disney.go.com/corporate/guidelines.html> [hereinafter Disney Corporate Governance Guidelines]. (A director who is, or whose immediate family member is, affiliated with or employed by a tax-exempt entity that received significant contributions (i.e., more than 2 percent of the annual contributions received by the entity or more than \$200,000 in a single fiscal year, whichever amount is lower) from the company or any executive officer (or any affiliates of the company or of any executive officer) within the preceding twelve-month period may not be deemed independent, unless the contribution was approved in advance by the board of directors; a director who is, or whose immediate family member is, an executive officer, general partner or significant equity holder (i.e., in excess of 10 percent) of an entity that is a paid provider of professional services to the Company (or any of its affiliates, any executive officer or any affiliate of an executive officer) that exceed \$60,000 (but do not exceed the greater of \$1 million or 2 percent of such other entity's consolidated gross revenues) within the preceding twelve month period may not be deemed independent.).

(n40)Footnote 40. Directors must devote sufficient time to prepare for and attend board and committee meetings and stay informed about the corporation's performance. While time commitments vary among companies, generally the time required of directors has significantly increased in recent years as federal laws and listing rules have added additional responsibilities for independent directors and members of various committees (particularly audit committee members). ABA Corporate Director's Guidebook 49-50. *See* Korn/Ferry Int'l, 33rd Annual Board of Directors Study 23 (2006) ("Respondents estimate they devote an average of 17 hours a month to director duties.").

(n41)Footnote 41. The commentary to NYSE Listed Company Manual § 303A.09 states that in their corporate governance guidelines companies may address substantive qualification requirements, including limiting the number of boards on which a director may sit.

(n42)Footnote 42. NACD Report on Director Professionalism 14, 26.

(n43)Footnote 43. The GM guidelines provide for a retirement age of 72, although directors have the flexibility to voluntarily retire at age 70, if they desire. GM Corporate Governance Guidelines, Guideline 15. *See also* § 7.01[2][c] *below* for discussion of director tenure and retirement age.

(n44)Footnote 44. NACD Report on Director Professionalism 14. The NACD favors a strong director evaluation process to assure effective director participation. However, the NACD recognizes that predetermined criteria, such as term or age limits, may serve as an alternate means for determining when board service should end. NACD Report on Director Professionalism 14.

(n45)Footnote 45. *See* NACD Report on Director Professionalism 14.

(n46)Footnote 46. NACD Report on Director Professionalism 15. The NACD supports the continued membership of a director on the board who has had a change in professional responsibilities, if the board determines that such a director continues to make a contribution to the organization.

(n47)Footnote 47. NACD Report on Director Professionalism 4, 5.

(N48)Footnote 48. Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1(m)(3) (audit committee). *See, e.g.*, Report of the American Bar Association Task Force on Corporate Responsibility 66 (Mar. 31, 2003) *available at*

www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, *59 Bus. Law. 145 (2003)* [hereinafter ABA Corporate Responsibility Report] (recommending the establishment of a compensation committee, a legal compliance committee, a corporate governance committee and an audit committee composed of independent directors). Both NYSE and NASDAQ listed companies are required to have independent audit committees. NYSE Listed Company Manual § 303A.07(b); NASD Rule 4350(d). NYSE listing standards also require a nominating/corporate governance committee and compensation committee composed entirely of independent directors. NYSE Listed Company Manual §§ 303A.04(a), 303A.05(a). NASDAQ listing rules require that the compensation of executive officers must be determined (or recommended for the board's determination) either by a majority of the independent directors or a compensation committee comprised solely of independent directors and that director nominees must be selected (or recommended for the board's selection) either by a majority of the independent directors or a nominations committee comprised solely of independent directors. NASD Rule 4350(c)(3), (4).

(n49)Footnote 49. The NACD has long recommended that boards should require the three key committees--audit, compensation and nominating or governance--include only independent directors. *See* NACD Report on Director Professionalism 7.

(n50)Footnote 50. In order to be independent, an audit committee member (i) may not accept any direct or indirect compensatory fee from the company or any of its subsidiaries, other than compensation for service as a director and certain types of deferred compensation and (ii) may not be an "affiliated person" of the company. Sarbanes-Oxley Act § 301, *15 U.S.C. § 78j-1*; 1934 Act Rule 10A-3, *17 CFR § 240.10A-3 (2003)*. An "affiliated person" is defined as "a person that, directly or indirectly through one or more of its intermediaries, controls, or is controlled by, or is under common control with, the person specified." 1934 Act Rule 10A-3, *17 CFR § 240.10A-3 (2003)*. "Control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 1934 Act Rule 10A-3, *17 CFR § 240.10A-3 (2003)*.

(n51)Footnote 51. NYSE Listed Company Manual § 303A.07; NASD Rule 4350(d).

(n52)Footnote 52. NYSE Listed Company Manual § 303A.07; NASD Rule 4350(d).

(n53)Footnote 53. NASD Rule 4350(d).

(n54)Footnote 54. Sarbanes-Oxley Act § 407, *15 U.S.C. § 7265*; Regulation S-K Item 401(h), *17 CFR § 229.401 (2003)*. An audit committee "financial expert" is a person who has (i) an understanding of financial statements, generally accepted accounting principles ("GAAP"), internal controls and procedures for financial reporting and audit committee functions; (ii) an ability to assess the general application of GAAP in connection with accounting for estimates, accruals and reserves; and (iii) experience in preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity comparable to that which can be expected to be raised by the company's financial statements, or experience in actively supervising one or more persons engaged in such activities. An audit committee "financial expert" may gain this experience as a result of (a) education and experience as a public accountant, auditor, principal financial officer, controller or principal accounting officer of a company or position involving similar functions; (b) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; (c) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or (d) other relevant experience. Regulation S-K Item 401(h)(2), *17 CFR § 229.401 (2003)*.

(n55)Footnote 55. The commentary to NYSE Listed Company Manual § 303A.07 requires that audit committee members must be financially literate, as determined by the board in its business judgment, or must become financially literate within a reasonable period of time following their appointment. In addition, at least one member of the committee (who need not be the committee chair) must have "accounting or related financial management expertise." The NYSE does not require that a listed company's audit committee include a person who satisfies the definition of an

audit committee expert set out in Item 401(h) of Regulation S-K (discussed above), but a board may presume that such a person qualifies as having the requisite expertise. NYSE Listed Company Manual § 303A.07 Commentary. NASD Rule 4350(d) requires that audit committee members be able to read and understand financial statements at the time of appointment. In addition, at least one committee member must have past employment experience in finance or accounting, professional certification in accounting or other comparable experience or background. A director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K is presumed to qualify. NASD Rule 4350(d).

(n56)Footnote 56. *See* DGCL § 141(e); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989) ; *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985) ; BJR at 198; ABA Corporate Director's Guidebook 14.

(n57)Footnote 57. *See* DGCL § 141(e) (directors are "fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors."); *see also* *N.Y. Bus. Corp. Law* § 717 (McKinney 2003); BJR at 199.

(n58)Footnote 58. *Brehm v. Eisner*, 746 A.2d 244, 261 (Del. 2000) (citation omitted).

(n59)Footnote 59. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) ("At a minimum, for a report to enjoy the status conferred by § 141(e), it must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind reliance.").

(n60)Footnote 60. NYSE Listed Company Manual § 303A.09 Commentary.

(n61)Footnote 61. *See, e.g.*, GM Corporate Governance Guidelines, Guideline 26 ("The Board welcomes the regular attendance at each Board meeting of non-Board members who are in the most senior management positions of the Corporation. Should the Chairman and Chief Executive Officer want to add additional people as attendees on a regular basis, it is expected that this suggestion would be made to the Board for its concurrence.").

(n62)Footnote 62. NYSE Listed Company Manual § 303A.06 Commentary; 1934 Act Rule 10A-3(b)(4), (5), 17 *CFR* § 240.10A-3 (2003).

(n63)Footnote 63. NYSE Listed Company Manual § 303A.05 Commentary.

(n64)Footnote 64. NYSE Listed Company Manual § 303A.04 Commentary.

(n65)Footnote 65. Note that an American Bar Association task force has recommended that public corporations adopt practices in which: (i) the board has responsibility for approving the selection, retention and compensation of the general counsel; (ii) executive sessions are scheduled between the general counsel and a committee of independent directors to discuss legal compliance matters; and (iii) reporting protocols include "a direct line of communication" for internal and outside lawyers to inform the general counsel of illegal conduct or breaches of fiduciary duties to the corporation. ABA Corporate Responsibility Report 32.

(n66)Footnote 66. *See, e.g.*, ABA Corporate Director's Guidebook 42.

(n67)Footnote 67. *See, e.g.*, Tyco International, Board Governance Principles 8 (Amended December 2006) [hereinafter Tyco Governance Principles] *available at* www.tyco.com/www/Documents/pdf/tyco_board_principles.pdf. ("Directors receive the agenda and materials for regularly scheduled meetings in advance. Best efforts will be made to make materials available as soon as one week in advance, but no later than three days in advance.").

(n68)Footnote 68. "The board" should satisfy itself that there is an overall annual agenda of the matters that require recurring and focused attention such as the achievement (as well as periodic re-examination and updating) of

operational and financial plans, the performance of the CEO and other members of executive management, an evaluation of board and committee performance, and the adequacy and appropriateness of corporate systems and controls that address legal compliance, risk management, corporate policy supervision, financial management and timely and accurate financial reporting and other disclosures." ABA Corporate Director's Guidebook 42.

(n69)Footnote 69. *See, e.g.*, GE Governance Principles, Principle 11 ("Prior to each board meeting, the CEO will discuss the other specific agenda items for the meeting with the presiding director..."); Tyco Governance Principles 8 ("The lead director, in consultation with the Chairman/CEO, is responsible for setting meeting agendas with input from the directors.").

(n70)Footnote 70. Structural flaws in the flow of material information and analysis to outside directors, such as nearly exclusive reliance on senior executive officers or advisers selected by such officers for information and guidance about corporate affairs, undermine effective and independent oversight by outside directors. ABA Corporate Responsibility Report 26. Corporate governance principles can address this concern by setting forth policies designed to "provide the directors with timely and sufficient information and analysis necessary to the discharge of their oversight responsibilities." ABA Corporate Responsibility Report 26. "One of the key ingredients for empowerment of any board is knowledge. Information flow, therefore, is a key prerequisite for directors to fulfill their oversight and decision-making functions ... While management should establish formal processes and communication channels to provide information to directors, directors should also seek information from carefully selected experts and other non-management sources on which they can rely in good faith. In addition, directors should cultivate an environment that encourages candid delivery of the most useful information, on a real-time basis." NACD Report on Director Liability 20.

(n71)Footnote 71. Ira M. Millstein, *The Evolution of the Certifying Board*, 48 *Bus. Law* 1485, 1490-1491 (Aug. 1993). *See In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (*Del. Ch.* 2003) ("The alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation ... Viewed in this light, plaintiffs' ... complaint sufficiently alleges a breach of the Director's obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant Director's conduct fell outside the protection of the business judgment rule.").

(n72)Footnote 72. *See e.g.*, GE Governance Principles, Principle 11; GM Corporate Governance Guidelines, Guideline 29; Disney Corporate Governance Guidelines, Guideline 13.

(n73)Footnote 73. ABA Corporate Director's Guidebook 41.

(n74)Footnote 74. ABA Corporate Director's Guidebook 14.

(n75)Footnote 75. NYSE Listed Company Manual § 303A.09 Commentary.

(n76)Footnote 76. Report of the NACD Blue Ribbon Commission on Director Compensation (1995, updated 2006).

(n77)Footnote 77. Report of the NACD Blue Ribbon Commission on Director Compensation (1995, updated 2006).

(n78)Footnote 78. In 2006 the United States Department of Justice, the SEC and the IRS instituted investigations against numerous companies regarding whether companies manipulated their stock-option grants to make them more lucrative (including whether companies back-dated or forward-dated such option grants). Additionally, in August 2006 the SEC adopted amendments to the disclosure requirements for executive and director compensation, related person transactions, director independence and other corporate governance matters, and securities ownership of officers and directors. These changes represent the first overhaul of executive and director compensation disclosure in over 14 years. These new rules require more disclosures concerning programs, plans and practices relating to the granting of options, including in particular the timing of option grants in coordination with the release of material nonpublic information and the selection of exercise prices that differ from the underlying stock's price on the grant date. For a more detailed

discussion of the changes to the executive compensation rules, *see* Chapter 10.

(n79)Footnote 79. *See, e.g.,* Ira M. Millstein, *Testimony Concerning the Role and Independence of Public Company Boards, the Professionals Upon Whose Advice They Must Rely and the Role of Compensation Before the Senate Committee on Banking, Housing and Urban Affairs* 12 (Feb. 27, 2002) ("As a matter of best practice ... stock options should be avoided altogether-especially those exercisable within a short period.").

(n80)Footnote 80. *In re eBay, Inc. S'holders Litig., CA 1998- NC, 2004 Del. Ch. LEXIS 4, at *9 (Jan. 23, 2004)* (where the value of options granted to a director "potentially run into the millions of dollars, one cannot conclude realistically that [such a director] would be able to objectively and impartially consider a demand to bring litigation against those to whom he is beholden for his current position and future position on eBay's board."). *See also* § 16.01[4] *below* (discussing application of corporate waste doctrine in "interested director" executive compensation cases).

(n81)Footnote 81. Frederick W. Cook & Co., Inc., Memorandum re: The Implications of "Enron" for Executive and Director Compensation 6 (Feb. 6, 2002).

(n82)Footnote 82. *See e.g.,* GM Corporate Governance Guidelines, Guideline 5 (the board and management will conduct a comprehensive orientation process and continuing education programs for its directors).

(n83)Footnote 83. NYSE Listed Company Manual § 303A.09 Commentary.

(n84)Footnote 84. Directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs. *See* CII Policies 4.

(n85)Footnote 85. ISS Corporate Governance Quotient, *available at* www.isscgq.com/abouttheratings.htm.

(n86)Footnote 86. NYSE Listed Company Manual § 303A.09 Commentary.

(n87)Footnote 87. NYSE Listed Company Manual § 303A.09 Commentary.

(n88)Footnote 88. NACD, Report of the NACD Blue Ribbon Commission on CEO Succession 4 (1997).

(n89)Footnote 89. *See* NACD Report on Director Professionalism 7; NACD Report on Performance Evaluation 13.

(n90)Footnote 90. NACD Report on Director Professionalism 19. [B]ecause directors themselves own the process by which they are renominated to shareholders for election, self-evaluation by the board and by directors can send a strong signal of accountability to shareholders, while providing assurance to directors themselves that their good work will not go unnoticed." Report of NACD Commission on Director Professionalism 17.

(n91)Footnote 91. NYSE Listed Company Manual § 303A.09 Commentary. Board self-evaluation has long been recommended as a best practice by the NACD and other organizations. *See* Report of the NACD Blue Ribbon Commission on Board Evaluation vii-viii (2001); ALI Principles of Corporate Governance § 302, Comment a.4 ("The board of directors has five primary functions, [one of which is to] evaluate board processes and performance."); Business Roundtable Principles at 9 ("It is the responsibility of the board and its corporate governance committee to ... oversee the ... evaluation of the board and its committees."); CalPERS Core Principles and Guidelines, Core Principle B.3 ("The board establishes performance criteria for itself and periodically reviews board performance against those criteria.").

(n92)Footnote 92. NYSE Listed Company Manual § 303A.09 Commentary.

(n93)Footnote 93. NYSE Listed Company Manual §§ 303A.04-06 Commentary.

(n94)Footnote 94. For a sample board evaluation, *see* the Sample Board & Board Committee Self Evaluation Form attached as Appendix 6-B to this chapter.

(n95)Footnote 95. *See* Katherine McG. Sullivan and Holly J. Gregory, *Board Self Assessment*, 16 J. Corp. Governance 6, 6 (Nov./Dec. 1995); Katherine McG. Sullivan and Holly J. Gregory, *Selecting a New Board Is a Negotiating Challenge*, Nat'l L.J., at C10 (Apr. 15, 1996); NACD Report on Performance Evaluation 13.

(n96)Footnote 96. An argument can be made for attorney-client communication protection attaching to the completed evaluation forms if they are designed to provide input to counsel, who is then to advise the board on efforts to improve governance processes. However, the strength of this argument has not been tested, and it is therefore uncertain whether a court will protect evaluation materials from discovery on these grounds.

(n97)Footnote 97. Document retention policies should be reviewed, as well as the limits on any routine document destruction that arise in the context of an investigation or institution of a lawsuit.

(n98)Footnote 98. *See, e.g.*, Tyco Governance Principles 9 ("The Nominating and Governance Committee coordinates an annual evaluation process by the directors of the board's performance and procedures, including evaluation of individual directors."); General Electric Company, Nominating and Corporate Governance Committee: Key Practices, P available at http://www.ge.com/company/governance/principles/governance_principles07.pdf ("[T]he board and each of the committees will perform an annual self-evaluation ... [E]ach director will provide to an independent governance expert his or her assessment of the effectiveness of the board and its committees, as well as director performance and board dynamics.").

(n99)Footnote 99. Katherine McG. Sullivan and Holly J. Gregory, *Board Self Assessment*, 16 J. Corp. Governance 6, 9 (Nov./Dec. 1995).

(n100)Footnote 100. Katherine McG. Sullivan and Holly J. Gregory, *Board Self Assessment*, 16 J. Corp. Governance 6, 9-10 (Nov./Dec. 1995).

(n101)Footnote 101. NYSE Listed Company Manual § 303A.05 (the compensation committee has the responsibility to "review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as determined by the board), determine and approve the CEO's compensation level based on this evaluation"); Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 4-5, 17-18 (2003); Robert Todd Lang, Spencer G. Smul & Howard B. Dicker, *Executive Compensation and Corporate Governance*, in SEC Proxy and Compensation Rules § 3.2[8] PP 3 and 8 (Aspen Law and Business: 2nd ed., 2001 supplement).

(n102)Footnote 102. NACD Report on Performance Evaluation 2.

(n103)Footnote 103. NACD Report on Performance Evaluation 3-4.



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Corporate Governance: Law and Practice

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CHAPTER 6 CORPORATE GOVERNANCE GUIDELINES FOR BOARD PRACTICES AND PROCEDURES

1-6 Corporate Governance: Law and Practice § 6.03

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§ 6.03 Other Common Corporate Governance Guideline Topics

Corporate governance guidelines frequently address additional topics such as the selection and invitation of new directors, executive sessions, and board leadership structure.

[1] Selecting and Inviting New Directors

While not required to be addressed in corporate governance guidelines, both the NYSE and the NASDAQ require listed company boards to delegate the process of identifying qualified director nominees, and overseeing the board's selection of the slate of director nominees, to an independent body.ⁿ¹

Many best practices documents and institutional investors have recommended that information about the director nomination process be disclosed to shareholders (for example, through published charters or guidelines). Under SEC rules adopted in 2003, public companies must disclose in their proxy statements certain information regarding the policies and procedures used in the board's selection of nominees.ⁿ² Among other things, disclosure is required in the proxy statement about the role played in the nominating process by a nominating committee and whether the board will consider for nomination candidates recommended by shareholders. Assuming that shareholder candidates will be considered for nomination by the board, the material terms of any policy relating to such consideration and the procedure shareholders should follow to submit candidates for consideration must be disclosed. In addition, any qualities and skills that the nominating committee considers necessary for service as a director must be disclosed.

Guidelines may also address the manner in which potential director nominees are invited to the board. As part of the cultural shift away from a CEO-dominated nominating process, some boards state in guidelines that such invitations are extended by the board of directors through the chairman of the nominating/governance committee or another director.ⁿ³

[2] Executive Sessions

NYSE and NASDAQ rules require that non-management/independent directors convene regularly in executive sessions without management participation.ⁿ⁴ Holding regular sessions outside of management's presence provides an opportunity for management performance to be fully critiqued and for other issues related to management to be explored, for example, issues of succession and compensation. Corporate governance guidelines and principles often

address the frequency with which executive sessions are held. They may also address who convenes and chairs such sessions and the decision-making authority of the body.ⁿ⁵ If the chairman of the board is not qualified to preside at the executive sessions (because he or she is a member of management or not independent), the board should determine who will preside at executive sessions or, if the presiding position is to rotate, what process is used. NYSE listing rules require that if one director is to preside at executive sessions, his or her name must be disclosed in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.ⁿ⁶ If there will not be an identified presiding director, the company must disclose the procedure by which a presiding director is selected for each executive session.ⁿ⁷ A non-management director must preside over each executive session of the non-management directors, though the same director is not required to preside at all such sessions. It is becoming increasingly common to provide the opportunity for an executive session at every board meeting, at least among the larger public companies.

[3] Board Leadership Structure

The board's duty to monitor management performance creates a potential conflict for a board chairman who serves simultaneously as the CEO (or in another position in the company). The CEO must lead the management team; the chairman must lead the board in monitoring the performance of the CEO and the management team. Some governance reformers view separation of the roles of chairman and CEO or, at least, the appointment of a lead independent director, as an important means of providing checks and balances within the board's governance structure to address this conflict.ⁿ⁸

Independent leadership is critical to positioning the board as an objective body distinct from management and, in particular, to the board's ability to: (i) identify the issues it should focus on including, in particular, the strategic issues of importance; (ii) obtain the information it needs to assess management's performance against its chosen strategy, including the overall conduct of the business; and (iii) prevent any management efforts to obfuscate important issues or information needed, thereby hindering the board's ability to fulfill its responsibilities. This is intended to further support effective management as much as to ferret out bad decisions and poorly functioning systems.ⁿ⁹

The board cannot simply strip the title from a sitting chairman/CEO and hand it to someone else. Removing a title from such an individual looks like a demotion and sends a message that the board lacks confidence in the corporation's leadership. Instead, boards should view separation as a key issue to be resolved in succession, to be implemented when whoever is serving in both roles steps down. Our experience is that the lead director works for the chairman, with the result that complexities are increased and the inherent conflicts in the executive chairmanship are not resolved. While the appointment of a "lead" or "presiding" director, may be the beginning of the process ... it is not enough. Thus, while the institutionalization of a lead director may be better than nothing, a concerted effort should be made to institutionalize the concept of an independent chairman.ⁿ¹⁰

Where the chairman is not an independent director, a board may wish to appoint a lead independent director to help set the board agenda and determine board information needs, organize the board's evaluation of the CEO, lead the board in the case of a crisis involving management, and convene and preside at executive sessions.ⁿ¹¹ (The NYSE rules do not require that there be a single presiding director at all executive sessions; listed companies may have a procedure by which a different presiding director is selected for each executive session.ⁿ¹²)

Separation of the positions of CEO and chairman or alternatively naming a lead independent director are viewed by some as potentially confusing and inefficient, called for only when there is an unplanned and unexpected absence of a CEO.ⁿ¹³ Shareholders of some companies, particularly smaller companies, may rely on and depend upon the expertise and vision of a single individual and prefer to have the role of chairman and CEO filled by this person.ⁿ¹⁴ In contrast, institutional shareholders and commentators note that separating the positions of CEO and chairman, or creating a lead

independent director would most likely reduce the CEO's undue influence over the board.ⁿ¹⁵

[4] Director Resignation Policy

Unless otherwise provided in a company's articles of incorporation or bylaws, plurality votingⁿ¹⁶ is the standard for the election of directors at most companies. For example, Delaware law provides that unless otherwise provided by the certificate of incorporation or bylaws, "[d]irectors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors."ⁿ¹⁷ Current shareholder activism focused on this standard is causing companies to reconsider the voting standard for directors and a number of companies have adopted a majority vote standards.ⁿ¹⁸ In the 2006 proxy season more than 150 companies received shareholder proposals calling for adoption of a majority vote standard,ⁿ¹⁹ and such proposals tended to receive high votes in favor, and support from proxy advisors.ⁿ²⁰

A company that wishes to implement some variety of majority voting has the following options: (1) adopt a policy (in Corporate Governance Guidelines or as a separate policy) that a director will resign from the board if he or she does not receive a majority of votes cast "for" election ("director resignation"); (2) amend their Bylaws to include such a director resignation provision; (3) amend their Bylaws to provide that directors shall be elected by a majority of votes cast (a "majority vote standard"); or (4) amend their Certificate of Incorporation to include a majority vote standard.ⁿ²¹

A director resignation policy implemented in a company's Corporate Governance Guidelines would require a director to resign if the number of votes "withheld" from his or her election exceeded the number of votes received "for" his or her election.ⁿ²² This option gives the board discretion to accept or reject the resignation. The board could strengthen the policy by providing that the board would accept the resignation of a director "absent a compelling reason" and the policy could articulate examples of such compelling reasons (for example, if the director in question is also the CEO or the audit committee financial expert).ⁿ²³ Similarly, the board could amend their Bylaws to include a resignation provision,ⁿ²⁴ along the lines described above.

A decision to adopt a director resignation policy rather than a majority vote standard would presumably be based on the generally recognized issues relating to such a standard, including: (1) that where an incumbent director fails to get the requisite majority vote, he or she remains in office under the statutory "holdover director" rule,ⁿ²⁵ so that a resignation policy remains necessary to address such a situation; and (2) that the board requires some opportunity to address the potentially adverse effects on the corporation of a "failed election,"ⁿ²⁶ including but not limited to the disruption that may attend the need to hold another election.ⁿ²⁷

Alternatively, several companies have adopted a majority vote standard in their bylaws.ⁿ²⁸ In the future shareholders would be able to unilaterally alter the majority vote standard by amending the Bylaws without board approval.ⁿ²⁹ Finally, the board could amend their Certificate of Incorporation to incorporate a majority vote standard which would require both board and shareholder approval and therefore could not be amended by shareholders unilaterally.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority Limitations Business & Corporate Law Corporations Directors & Officers Scope of Authority Meetings Procedures Business & Corporate Law Corporations Directors & Officers Terms in Office General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. NYSE Listed Company Manual § 303A.04 and Commentary; NASD Rule 4350(c).

(n2)Footnote 2. 1934 Act Rule 14a-101, Item 7(d)(2), *17 CFR § 240.14a-101 (2003)*. The Second Circuit Court of Appeals has held that a company may not exclude, under 1934 Act Rule 14a-8(i)(8), a shareholder proposal that would require the company to place candidates nominated by the shareholders on the company's proxy in certain circumstances. (*American Federation of State, County & Municipal Employees Pension Plan v. American International Group*, Docket No. 05-2825-cv, Sept. 5, 2006). In this holding, the Court rejected the SEC's longstanding interpretation of the application of Rule 14a-8(i)(8) under the 1934 Act as permitting a company to exclude a shareholder proposal granting shareholder increased access to proxy statements. The rule states that a company may exclude a shareholder proposal from its proxy statement "[i]f the proposal relates to an election for membership on the company's board of directors or analogous governing body." The Court held that the Rule 14a-8(i)(8) applies "to shareholder proposals that relate to a particular election and not to proposals that ... would establish the procedural rules governing elections generally." At its open meeting on July 25, 2007 the SEC voted to approve two different (and conflicting) rulemaking proposals on "shareholder access." Although neither proposal would itself mandate access; both concern the means by which shareholder may seek to institute an access regime: One proposal would, under certain circumstances, grant shareholders the right to require a company to *include* in its proxy materials for a vote a proposal to adopt a binding bylaw entitling shareholders to access to company proxy materials. The other proposal would grant companies the ability to *exclude* from company proxy materials shareholder proposals seeking access under this proposal, a shareholder sponsoring any such proposal would have to do so by soliciting shareholders on its own, as has traditionally been the case. The SEC has requested comments on these proposals and the Chairman of the SEC has indicated his intention to having a clear rule on this issue in place for the 2008 proxy season.

(n3)Footnote 3. An invitation to join the GM Board is extended by the board via the chairman of the board and the CEO, together with an independent director (when appropriate). GM Corporate Governance Guidelines, Guideline 3.

(n4)Footnote 4. NYSE Listed Company Manual § 303A.03 and Commentary (non-management directors must meet at regularly scheduled executive sessions without management; if the non-management directors include directors who are not independent under NYSE rules, listed companies should schedule an executive session including only independent directors at least once a year); The NYSE has proposed to amend this rule to clarify that the "executive session" meetings that it requires be regularly held may be held among only independent directors (and are not required to also include non-independent, non-management directors, but in the directors' discretion may do so, although at least one such meeting each year should include only independent directors). *See* SEC File No. SR-NYSE-2005-81 Amendment No. 2 (June 20, 2007). NASD Rule 4350(c)(2) (boards must convene regular meetings of "independent" directors in executive session).

(n5)Footnote 5. *See, e.g.,* NACD Report on Board Evaluation 30, *citing* NACD Report on Director Professionalism 6-7 ("Regularly scheduled executive sessions afford independent directors an opportunity to react to management proposals and other actions in an environment free from formal or informal management constraints."); The Conference Board, Findings and Recommendations, Part 2 at 6 (Jan. 9, 2003) (recommending frequent, regular meetings of independent directors to facilitate proper oversight of the CEO).

(n6)Footnote 6. NYSE Listed Company Manual § 303A.03 Commentary.

(n7)Footnote 7. NYSE Listed Company Manual § 303A.03 Commentary.

(n8)Footnote 8. Millstein & MacAvoy, *The Recurrent Crisis in Corporate Governance* (Ch. 7) 95; Institutional Shareholder Services, U.S. Proxy Voting Manual 2 (2005) ("Generally vote FOR shareholder proposals requiring the position of chairman be filled by an independent director unless there are compelling reasons to recommend against the proposal, such as a counter balancing governance structure."). CII Policies state that the board should be chaired by an independent director and that the CEO and chair roles should be combined in very limited circumstances (Council of Institutional Investors, *Corporate Governance Policies*; (March 1998, most recently revised April 2006) pg. 3); ISS also

believes that the positions of the chairman and CEO should be separated and the chairman should be an independent outsider (Governance Standard 12) (Noting that "the positions of chairman and CEO are two distinct jobs with different job responsibilities ... Some believe that having the same person hold the positions of the chairman and CEO calls into question whether the board can adequately oversee and evaluate the performance of senior officers (including the CEO) and the company (Commentary on Governance Standard 12).") ISS will generally vote in favor of "shareholder proposals requiring the position of chairman be filled by an independent director unless there are compelling reasons to recommend against the proposal, such as a counterbalancing governance structure." (ISS 2007 U.S. Proxy Voting Manual, Chapter 2.) Examples of such governance structures include a "designated lead director, elected by and from the independent board members with clearly delineated duties." (ISS 2007 U.S. Proxy Voting Manual, Chapter 2.) Additionally, ISS has amended its "Chairman/CEO Separation" rating in its Corporate Governance Quotient ("CGQ") to be consistent with its voting policy on the topic. (ISS US Corporate Governance Policy 2007 Updates (pg. 24).)

(n9)Footnote 9. Millstein & MacAvoy, *The Recurrent Crisis in Corporate Governance* (Ch. 7) 95.

(n10)Footnote 10. Millstein & MacAvoy, *The Recurrent Crisis in Corporate Governance* (Ch. 7) 118.

(n11)Footnote 11. *See* NACD Report On Director Professionalism 6.

(n12)Footnote 12. NYSE Listed Company Manual § 303A.03 Commentary (The name of the director presiding at the executive sessions, or the procedure by which the presiding director is selected for each executive session, must be disclosed in the proxy statement (or, if the company does not file a proxy statement, in the company's annual report), together with information about how interested parties can communicate with the presiding director or the non-management directors as a group.).

(n13)Footnote 13. *Business Roundtable Principles* at 15 ("Some corporations have found it useful to separate the roles of CEO and chairman of the board to provide continuity of leadership in times of transition.").

(n14)Footnote 14. AFL-CIO Proxy Voting Guidelines IV.A.7 ("[I]n certain circumstances, such as a small-cap company with a limited group of leaders, it may be appropriate for [the chairman and CEO] positions to be combined for some period of time.").

(n15)Footnote 15. *The Conference Board, Findings and Recommendations, Part 2, Principle I, Best Practice 1a* ("Each corporation should give careful consideration to separating the offices of Chairman of the Board and CEO, with those two roles being performed by separate individuals. The Chairman would be one of the independent directors."); *AFL-CIO Proxy Voting Guidelines IV.A* ("[T]he trustees believe that having an independent director serve as chairperson enhances the board's independence and effectiveness."); *ISS U.S. Proxy Voting Manual*; *TIAA-CREF Policy Statement 8* ("[W]hen the board chooses not to separate the positions [of chairman and CEO], it should designate a lead or presiding director who would preside over executive sessions of independent directors and ... participate actively in the preparation of board agendas."); *MacAvoy & Millstein, The Recurrent Crisis in Corporate Governance* 95.

(n16)Footnote 16. Under plurality voting, a director is elected if he or she receives more affirmative votes cast "for" his or her election than for another nominee, without regard to the number of "withheld" votes or votes not cast. Under a majority vote requirement, a nominee is elected only if he or she receives a majority of the votes cast.

(n17)Footnote 17. DGCL § 216(3). New York corporate law provides that unless a company's certificate of incorporation provides otherwise, a plurality of all the votes cast at a meeting at which a quorum is present is sufficient to elect a director. *New York Business Corporation Law § 614(a)* (2006).

(n18)Footnote 18. On October 24, 2006 the NYSE filed with the SEC a proposed amendment of NYSE Rule 452 and corresponding NYSE Listed Company Manual Section 402.08 that would eliminate broker discretionary voting on the election of shares held in client accounts, as currently permitted, when the broker has not timely received voting

instructions from the client. (File No. SR-NYSE-2006-92) The proposed amendment is subject to approval by the SEC and will be applicable to proxy voting by NYSE member-firm brokers with respect to shareholder meetings held on or after January 1, 2008, except to the extent that a meeting was originally scheduled to be held in 2007 but was adjourned to 2008. NYSE Rule 452 allows brokers who have not received voting instructions from the beneficial owner for the shares at least 10 days before a scheduled meeting to vote on "routine" matters. Director elections have been considered routine. However, "shareholders and others have long argued against such a designation, particularly in recent years as institutional investors have pushed for majority voting in director elections and the ability to nominate board candidates." (ISS Corporate Governance Blog, "NYSE Proposes to Bar Election-Related Broker Votes in 2008", Oct. 27, 2006.) The NYSE's press release announcing the proposed change stated that "the goal of the NYSE has been to not allow the broker to vote on any proposal that substantially affects the rights of shareholders ... today the election of directors is simply too important to ever be considered routine, even where the election is uncontested. Shareholder voting on the election of directors is a critical component of good corporate governance." (NYSE News Release, "NYSE Adopts Proxy Working Group Recommendation to Eliminate Broker Voting In 2008", Oct. 24, 2006).

(n19)Footnote 19. Institutional Shareholder Services, *Policy Formulation and Outreach Process for the 2007 Proxy Season: Policy Review and Comments Period* (Sept. 20, 2006) at 3 [hereinafter ISS 2007 Proxy Season Policy].

(n20)Footnote 20. "ISS will generally recommend FOR precatory and binding resolutions requesting that the board change the company's bylaws to stipulate that directors need to be elected with an affirmative majority of votes cast, provided it does not conflict with the state law where the company is incorporated. Binding resolutions need to allow for a carve-out for a plurality vote standard when there are more nominees than board seats." *See* ISS U.S. Corporate Governance Policy 2007 Updates (2006) at 11.

(n21)Footnote 21. State law may provide that in order for a company to implement a majority vote standard, an amendment to their Certificate of Incorporation is required. "Directors shall, except as otherwise required by this chapter or by the certificate of incorporation as permitted by this chapter, be elected by a plurality of votes cast at a meeting of shareholders by the holders of shares entitled to vote in the election." (New York State Consolidated Laws, Chapter 4, Article 6, Section 614(a)). "Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting which a quorum is present." (Indiana Code, Title 23, Article 1, Chapter 30, Section 9(a)).

(n22)Footnote 22. ISS states in its U.S. Corporate Governance 2007 Policy Updates that companies "are strongly encouraged to also adopt a post-election policy (also known as a director resignation policy)"... *See* ISS U.S. Corporate Governance Policy 2007 Updates (2006) at 11. Policies should address the specific circumstances of each company.

(n23)Footnote 23. Some companies, such as The Procter & Gamble Co. have adopted such policies. *See* The Procter & Gamble Company Board of Directors Corporate Governance Guidelines *available* at http://www.pg.com/company/our_commitment/corp_gov/corp_gov_guidelines.jhtml: "In any non-contested election of directors, any director nominee who receives a greater number of votes "withheld" from his or her election than votes "for" such election according to certified election results shall immediately tender his or her resignation as a Director to the Board of Directors. Within ninety days following the certification of the election results, the Board of Directors will decide, after taking into account the recommendation of the Governance and Public Responsibility Committee (in each case excluding the nominee in question) whether to accept the resignation. *Absent a compelling reason for the director to remain on the Board, the Board of Directors shall accept the resignation.*" (emphasis added).

(n24)Footnote 24. Under Delaware law, the board is permitted to amend bylaws only if authorized to do so by the certificate of incorporation: DGCL § 109(a).

(n25)Footnote 25. DGCL § 141(b): "Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal."

(n26)Footnote 26. A "failed election" occurs when one or more nominees are not seated on the board. The consequences can include: (1) breach of an executive employment agreement and possible severance liability, where the nominee is also the CEO or other senior executive; (2) change in control that accelerates debt or triggers changes in agreements, where shareholders fail to elect a specified percentage of directors; (3) altered relationships among shareholders of different classes, where holders of one class of securities are to elect a fixed number of directors; (4) non-compliance with listing standards requiring independent directors or directors with particular qualifications; (5) altered consequences of having a classified board; and (6) altered dynamics of control contests, where a dissident group with minority representation on the board can enlarge its percentage of directors without the need for a direct proxy contest. *See* Committee on Corporate Laws, ABA Section of Business Law, *Changes in the Model Business Corporation Act--Proposed Amendments to Chapters 8 and 10 Relating to Voting by Shareholders for the Election of Directors* (Mar. 6, 2006) ("*ABA Report*") 15-16.

(n27)Footnote 27. These (and other) negative aspects of a majority vote standard have led the American Bar Association Committee on Corporate Laws ("*ABA*") to recommend against a majority vote standard as a generally applicable director election standard and to propose alternative statutory provisions that provide corporations greater flexibility in their director election process, including modification of the holdover director rule and a "modified plurality approach." Under the "modified plurality approach," the current plurality standard would apply "but a director who receives more votes against than for his or her election would cease to hold office 90 days after the election unless the director is confirmed in office by the board;" under a variation of that approach, the director would not be automatically removed, but could be removed by the board during the 90-day period. Both provisions recommended by the ABA would require statutory amendments to the Delaware corporation statute.

(n28)Footnote 28. Examples of companies that have amended bylaws to provide for majority voting in the election of directors include General Electric Co., The Walt Disney Co., Dell Inc., Intel Corporation, Dillard's Inc., Trimeris Inc., Automatic Data Processing, Inc. and N-Viro International Corp.

(n29)Footnote 29. DGCL § 216 was amended on June 27, 2006 (effective August 1, 2006) to include the following: "A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors." *See* S. 322, 143rd Gen. Assem. § 5 (Del. 2006).



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CHAPTER 6 CORPORATE GOVERNANCE GUIDELINES FOR BOARD PRACTICES AND PROCEDURES

1-6 Corporate Governance: Law and Practice § 6.04

AUTHOR: Holly J. Gregory

§ 6.04 Creating and Disclosing Corporate Governance Guidelines

The task of developing corporate governance guidelines is often delegated to the nominating/governance committee or other body of independent directors in the first instance. It often involves feedback from management and the board, and usually the guidelines are approved by the full board. As a matter of best practice, the Business Roundtable recommends that the corporate governance committee "develop and recommend to the board a set of corporate governance principles."¹ The NYSE Listed Company Manual requires that the nominating/governance committee charter include among the committee's purpose and responsibilities, the development (for recommendation to the board) of a set of corporate governance principles.²

Generally the body drafting a set of guidelines has significant discretion concerning the topics to include (although NYSE companies must address certain topics³). For this reason, having a full discussion at the board level prior to final adoption is important both to obtain formal approval and to provide education about the matters included. This discussion may be likened to a board evaluation discussion focused on how the board is functioning and in what areas improvements may be called for.

Generally, governance guidelines are made public.⁴ The Business Roundtable suggests that "[governance] principles should be communicated to the corporation's stockholders and should be readily available to prospective investors and other interested persons."⁵ Additionally, TIAA-CREF's policy on corporate governance states that "[t]he board should develop a clear and meaningful set of governance principles and disclose them to shareholders on the company's website, as well as in the annual report or proxy statement."⁶

In drafting corporate governance guidelines and principles, a board should strive to create a culture of ethics, compliance with law, inclusiveness and dedication to the firm's viability. Additionally, drafters of corporate governance guidelines should attempt to make the exercise a transparent, inclusive process in which all board members and management have an opportunity to make meaningful contributions. Every board, whether of a publicly-traded or privately-held company, has significant discretion to consider and resolve governance issues for itself. Boards should do so actively, within the framework of applicable laws, regulations and listing rules, as well as the unique context of the company's business needs and environment.⁷ The process of determining governance procedures represents a valuable opportunity for directors to become vested in their responsibilities and to proactively discuss and decide how best to

approach those responsibilities as a collective body.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral
 OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityLimitationsBusiness &
 Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewBusiness & Corporate
 LawCorporationsGoverning Documents & ProceduresRecords & Inspection RightsGeneral OverviewSecurities
 LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. Business Roundtable, Principles of Corporate Governance 22 (May 2002), reproduced in Appendix A to this treatise.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.04(b)(i). *See also § 8.03[3] below.*

(n3)Footnote 3. The commentary to the NYSE Listed Company Manual § 303A.09 states that the following subjects must be addressed in corporate governance guidelines: director qualification standards; director responsibilities; director access to management and, as necessary and appropriate, independent advisors; director compensation; director orientation and continuing education; management succession; and annual performance evaluation of the board.

(n4)Footnote 4. The NYSE requires that companies have and maintain a publicly accessible website and such website must include a printable version of the listed company's Corporate Governance Guidelines. NYSE Listed Company Manual, § 303A.14. The company must also state in its annual proxy statement (or, if the company does not file an annual proxy statement, in the company's annual report) that its Corporate Governance Guidelines are available on the company's website. NYSE Listed Company Manual, § 303A.09.

(n5)Footnote 5. Business Roundtable, Principles of Corporate Governance 22 (May 2002).

(n6)Footnote 6. TIAA-CREF Policy Statement 6.

(n7)Footnote 7. Attached as Appendix 6-C to this chapter is a Comparison of Corporate Governance Guidelines & Codes of Best Practice: United States, which compares suggestions for board structure and practice by influential members of the corporate, institutional investor and legal communities to the governance guidelines used by the General Motors Board of Directors.



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Appendix 6-A Sample Corporate Governance Guidelines and Principles

1-6-A Corporate Governance: Law and Practice Appendix 6-A.syn

§ 6-A.syn Synopsis to Appendix 6-A: Sample Corporate Governance Guidelines and Principles

[6-A] Sample Corporate Governance Guidelines and Principles



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Appendix 6-A Sample Corporate Governance Guidelines and Principles

1-6-A Corporate Governance: Law and Practice [6-A]

[6-A] Sample Corporate Governance Guidelines and Principles

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The sample set of corporate governance guidelines and principles attached is intended to comport with corporate governance listing standards of the principal U.S. stock markets and generally accepted practices for boards of listed companies. It incorporates elements suggested or required by the corporate governance listing standards of the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq").

The NYSE requires U.S. listed companies to adopt and disclose a set of guidelines and principles that address: director responsibilities; director qualification standards, including independence; director orientation and continuing education; director compensation; annual board performance evaluation; director access to management; management succession; and board access to independent advisers.

Nasdaq's corporate governance listing standards do not require that listed companies adopt and disclose a set of corporate governance guidelines, although a number of Nasdaq companies do so.

*Corporate governance guidelines and principles are very specific to the needs and circumstances of the individual company. This sample provides only one fairly simple example. For additional information about governance guidelines, including provisions recommended by The Business Roundtable, the National Association of Corporate Directors and various institutional investors, see Gregory, *Comparison of Corporate Governance Guidelines and Codes of Best Practice: United States (2006)*, available from WG&M at <http://www.weil.com/wgm/pages/Controller.jsp?z=p&sz=CorpGov&db=wgm/WGMDoc.nsf&d=7fa691ef5e6d00ef85256d81004b74ba>. A shortened version of this comparison is attached as Appendix 6-C to this chapter.*

Please note that various factors unique to a company (including, among others, organizational structure, lines of business, and applicable requirements of local, regional or national law) may affect the provisions that should be addressed. Accordingly, while this sample includes standards and provisions that are appropriate generally for most publicly-traded U.S. companies, different and additional provisions may be appropriate in particular circumstances.

[NAME OF COMPANY]

Corporate Governance Guidelines and Principles

These Corporate Governance Guidelines and Principles were adopted by the Board of Directors (the "Board") of _____ (the "Company") [on / and amended through] [month] [day], [year].n*

*These Corporate Governance Guidelines and Principles are intended as a component of the flexible governance framework within which the Board, assisted by its committees, directs the affairs of the Company. While they should be interpreted in the context of all applicable laws, regulations and listing requirements, as well as in the context of the Company's Certificate of Incorporation and Bylaws, they are not intended to establish by their own force any legally binding obligations. [I]DIRECTOR RESPONSIBILITIES***

The role of the Board is to: (i) direct the affairs of the Company in the interests of the shareholders, including their interest in optimizing financial returns and the value of the Company over the long term; and (ii) set expectations about the tone and ethical culture of the Company.[A] Board Role

The Board fulfills its role (directly or by delegating certain responsibilities to its committees) by:

1. providing advice and counsel to the Chief Executive Officer and principal senior executives;
2. selecting, regularly evaluating, fixing the compensation of, and, where appropriate, replacing the Chief Executive Officer;
3. overseeing the conduct of the Company's business and strategic plans to evaluate whether the business is being properly managed;
4. reviewing and approving the Company's financial objectives and major corporate plans and actions;
5. reviewing and approving major changes in the appropriate auditing and accounting principles and practices;
6. providing oversight of internal and external audit processes and financial reporting;
7. providing oversight of risk assessment and protection processes and processes designed to promote legal compliance; and
8. performing such other functions as the Board believes appropriate or necessary, or as otherwise prescribed by rules or regulations.

[B] Care, Candor and Avoidance of Conflicts

The Company's directors recognize their obligation individually and collectively as the Board to pay careful attention and be properly informed. This requires regular attendance at board meetings and preparation for board meetings, including the advance review of circulated materials. The directors also recognize that candor and the avoidance of conflicts in fact and in perception are hallmarks of the accountability owed to the shareholders. Directors have a personal obligation to disclose a potential conflict of interest to the Chairman of the Board prior to any Board decision related to the matter and, if the Chairman in consultation with legal counsel determines a conflict exists or the perception of a conflict is likely to be significant, to recuse themselves from any discussion or vote related to the matter.[C] Integrity and Conduct

Each director is expected to act with integrity and to adhere to the policies in the Company's Code of Business Conduct and Ethics. Any waiver of the requirements of the Code of Business Conduct and Ethics for any director must be approved by the Board and promptly disclosed on the Company's website.[D] Confidentiality

Each director has an obligation to keep confidential all non-public information that relates to the Company's business. Such information includes, but is not limited to, information regarding the strategy, business, finances and operations of the Company, minutes, reports and materials of the Board and its committees, and other documents identified as confidential by the Company. Additionally, the proceedings and deliberations of the Board and its committees are confidential.[II]EXECUTIVE SESSIONS & INDEPENDENT BOARD LEADERSHIP

The [independent/non-management] directors meet regularly without members of management present in executive session, no less frequently than _____ times per year, and as otherwise determined by such directors. [If any of the non-management directors do not qualify as an "independent director" as set forth in Section V below, one or more additional executive sessions are held annually, attended only by independent directors.]n1

The executive sessions have such agendas and procedures as determined by the non-management and independent directors. The authority in such sessions to act on behalf of the Company or the Board on any matters requires an express delegation of authority by the Board.

[If the Company has a separate independent chairman, include a statement indicating that fact.][III] FORMAL EVALUATION OF THE CHIEF EXECUTIVE OFFICER

The Board has delegated to the Compensation Committee² the task of evaluating the Chief Executive Officer annually and reporting its recommendations to the Board. The Chairman of the Compensation Committee (together with the Lead Director or Chairman of the Board if the Chairman is an independent director) communicates the Board's conclusions to the Chief Executive Officer.

The evaluation is based on objective criteria including performance of the business, accomplishment of long-term strategic objectives, development of management, etc. The evaluation is used by the Compensation Committee in determining the Chief Executive Officer's compensation.[IV]MANAGEMENT DEVELOPMENT AND SUCCESSION PLANNINGn**

The Chief Executive Officer reports at least annually to the Board on the Company's program for management development and on succession planning, which the Board views as closely-related issues. In its consideration of these issues, it is the policy of the Board to consider issues related to CEO and senior executive selection and performance.

In addition, there is available on a continuing basis, and the Board and CEO periodically discuss, the Chief Executive Officer's recommendation as to a successor in the event of the sudden resignation, retirement or disability of the Chief Executive Officer.[A] Selection of Board Nominees

The Board is responsible for recommending director nominees to shareholders for election. The Board has delegated the screening process to the Nominating and Corporate Governance Committee.n3

The Nominating and Corporate Governance Committee is responsible for reviewing with the Board, on an annual basis, the appropriate skills and characteristics required of directors in the context of the current make up of the Board. This assessment includes issues of judgment, diversity, age, skills (such as an understanding of relevant technologies, international background, etc.), in the context of an assessment of the perceived needs of the Board at that point in time.

The Nominating and Corporate Governance Committee considers recommendations for Board candidates submitted by shareholders using the same criteria it applies to recommendations from the Committee, directors and members of management. Shareholders may submit recommendations by writing to the Committee at _____.

Invitations to serve as a nominee are extended by the Board itself via the Chairman of the Board and the Chairman of

the Nominating and Corporate Governance Committee.

[If applicable, include a reference to majority voting and/or director resignation policy]ⁿ⁴ [B] Board Independence ⁿ⁵

The Board has a majority of directors who are not officers or employees of the Company or its subsidiaries and who, in each case, the Board has affirmatively determined lack a "material relationship" with the Company (either directly or as a partner, controlling shareholder or executive officer of an organization that has a material relationship with the Company).

The Board defines a director as lacking a material relationship and therefore will be "independent" (subject to the guidance provided by the Listing Rules of the New York Stock Exchange) if he or she does not have any of the following relationships:

1. within the past three years

(i) is or has been employed by the Company or has an immediate family member who has been an executive officer of the Company;

(ii) has received, or has an immediate family member who has received, more than \$100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);ⁿ⁶

(iii) has provided significant advisory or consultancy services to the Company, and is, or has an immediate family member who is, affiliated as an executive officer, partner or controlling shareholder with a company or a firm that has provided such significant services (revenue of the greater of 2% of the other company's consolidated gross revenues or \$1 million is considered significant);

(iv) has been a significant customer or supplier of the Company or has been, or has an immediate family member who has been, a partner, controlling shareholder or executive officer of a company or firm that is (revenue of the greater of 2% of the other company's consolidated gross revenues or \$1 million is considered significant);

(v) (a) is, or whose immediate family member is, a current partner of a firm that is the company's internal or external auditor; (b) is a current employee of such a firm; (c) has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance; or (d) was, or has an immediate family member who was (but is no longer) a partner or employee of such a firm and personally worked on the Company's audit;

(vi) has been, or has an immediate family member who has been, employed by another company where any of the Company's current executive officers serve, or within the past three years served, on that company's compensation committee;

For these purposes, "immediate family member" includes a person's spouse, parent, sibling, child, mother- or father-in-law, son- or daughter-in-law or brother- or sister-in-law or anyone (other than domestic employees) who shares a person's home.ⁿ⁷

2. is an executive officer or chairman of the board of a tax-exempt entity that within the past 12 months

received significant contributions from the Company (revenue of the greater of 2% of the entity's consolidated gross revenues or \$1 million is considered significant); and

3. has any other relationships with the Company or with members of senior management that the Board determines to be material.

[C] Commitment and Limits on Other Activities

Directors are expected to limit the number of other boards (excluding non-profits) on which they serve to between _____ and _____, with the lower limit applying to directors who are engaged full-time in another business. Directors are asked to advise the Chairman of the Board and the Chairman of the Nominating and Corporate Governance Committee in advance of accepting an invitation to serve on another board.[D]

Term and Age Limits

As an alternative to term limits, the Nominating and Corporate Governance Committee formally reviews each director's continuation on the Board at the expiration of the director's term. The Board also has set an age limit of [_____] for directors.[E] Offer of Resignation Upon a Job Change

When a director's principal occupation or business association changes substantially from the position such director held when originally invited to join the Board, the director shall submit to the Chairman of the Nominating and Corporate Governance Committee an offer to resign. The Committee shall review whether it would be appropriate for the director to continue serving on the Board and recommend to the Board whether, in light of the circumstances, the Board should accept the proposed resignation or request that the director continue to serve.n8 [VI]DIRECTOR ORIENTATION AND CONTINUING EDUCATIONn**

The Board has delegated to the Nominating and Corporate Governance Committee the task of designing, with Company management, an appropriate orientation program for new directors that includes background material, meetings with senior management and visits to Company facilities. The Committee also explores, makes available, and designs and provides continuing education opportunities for directors, from time to time.[VII]DIRECTOR COMPENSATION AND STOCK OWNERSHIPn**

The Nominating and Corporate Governance Committee recommends to the Board for approval general principles for determining the form and amount of director compensation and subject to such principles, evaluates annually the status of Board compensation in relation to comparable U.S. companies (in terms of size, business sector, etc.), reporting its findings and recommendations to the Board for approval.n9

[Expand with a brief description of the components of director compensation, general principles for determining the form and amount of director compensation and any policy on stock ownership.]n10 [VIII]BOARD AGENDA, MATERIALS, INFORMATION AND PRESENTATIONS

The Chairman of the Board, with input from senior members of management and the Lead Director, establishes the agenda for each Board meeting. A schedule of agenda subjects to be discussed for the ensuing year is issued at the beginning of each year (to the degree these can be foreseen). Each director is free to suggest the inclusion of item(s) on the agenda.

Information and data that is important to the Board's understanding of the business is distributed in writing to the Board generally five to seven days before the Board meets, although this is not a strict standard, so as to allow for unusual circumstances. Management should ensure that material is as brief as possible while still providing the desired information.

As a general rule, Board meeting time is reserved for discussion. Presentations on specific subjects are forwarded to the

directors in advance so that directors may prepare, Board meeting time may be conserved, and discussion time may be focused. However, it is recognized that there may be occasions when an important issue arises without time for written background materials to circulate or the subject matter is not appropriate for written materials, such that more presentation time will be required.[IX]DIRECTOR ACCESS TO SENIOR MANAGERS AND INDEPENDENT ADVISERSn**

Directors have complete access to senior management and to the Board's advisers. Directors are expected to use good judgment to ensure that this contact is not distracting to the business operation of the Company, and that independent advisers are used efficiently.

The Board welcomes regular attendance of senior managers at Board meetings. Should the Chairman and Chief Executive Officer wish to suggest that a senior manager attend on a regular basis, such suggestion is made to the Board for its concurrence. The Board encourages management to bring managers into Board meetings who: (a) can provide additional insight into the items being discussed because of personal involvement in these areas, and/or (b) have future potential such that management believes the Board should have greater exposure to the individual.[X] BOARD INTERACTION WITH SHAREHOLDERS AND OTHERS/ANNUAL MEETINGS

Management, and, in particular, the Chief Executive Officer, speaks for the Company with shareholders, investors, employees, customers, suppliers, the press and others. The Chairman of the Board and, in certain circumstances, the Lead Director, speaks for the Board. Individual directors may, from time to time at the request of management, meet or otherwise communicate with various constituencies. If comments from the Board are appropriate, however, they should, in most circumstances, come from the Chairman. Directors are expected to take special care in all communications concerning the Company, in light of confidentiality requirements and laws prohibiting insider trading, tipping and avoidance of selective disclosure.

It is a policy of the Board that all Directors attend the Annual Meeting of Shareholders absent unusual circumstances. (The Company is required to disclose director attendance at such meeting in the Company's next proxy statement or on the Company's website).[XI]STANDING BOARD COMMITTEES

The Board currently has [three] committees: Audit, Compensation and Nominating and Corporate Governance.n11 Membership on such committees is limited to independent directors. The Board retains discretion to form new committees or disband current committees depending upon the circumstances.

The Nominating and Corporate Governance Committee recommends, after consultation with the Chairman of the Board and Chief Executive Officer, and with consideration of the desires of individual directors, the appointment of directors to various committees and the appointment of committee chairmen, for Board approval.[XII]ANNUAL BOARD AND COMMITTEE PERFORMANCE EVALUATIONSn**

The Board conducts an annual self-evaluation of its performance and the performance of its committees. The Nominating and Corporate Governance Committee recommends to the Board and its committees the methodology for such evaluations and oversees its execution.[XIII]COMMUNICATING WITH THE BOARD

Shareholders are invited to communicate to the Board or its committees by writing to: _____ .n12 [XIV] CORPORATE GOVERNANCE GUIDELINES

The Nominating and Corporate Governance Committee reviews these Guidelines periodically and recommends amendments to the Board as necessary.

These Guidelines are posted on the Company's website for communication to the Company's shareholders.n13 [I]DIRECTOR RESPONSIBILITIESn**

1-6-A Corporate Governance: Law and Practice [6-A]

The role of the Board is to: (i) direct the affairs of the Company in the interests of the shareholders, including their interest in optimizing financial returns and the value of the Company over the long term; and (ii) set expectations about the tone and ethical culture of the Company.[A] Board Role

The Board fulfills its role (directly or by delegating certain responsibilities to its committees) by:

1. providing advice and counsel to the Chief Executive Officer and principal senior executives;
2. selecting, regularly evaluating, fixing the compensation of, and, where appropriate, replacing the Chief Executive Officer;
3. overseeing the conduct of the Company's business and strategic plans to evaluate whether the business is being properly managed;
4. reviewing and approving the Company's financial objectives and major corporate plans and actions;
5. reviewing and approving major changes in the appropriate auditing and accounting principles and practices;
6. providing oversight of internal and external audit processes and financial reporting;
7. providing oversight of risk assessment and protection processes and processes designed to promote legal compliance; and
8. performing such other functions as the Board believes appropriate or necessary, or as otherwise prescribed by rules or regulations.

[B] Care, Candor and Avoidance of Conflicts

The Company's directors recognize their obligation individually and collectively as the Board to pay careful attention and be properly informed. This requires regular attendance at board meetings and preparation for board meetings, including the advance review of circulated materials. The directors also recognize that candor and the avoidance of conflicts in fact and in perception are hallmarks of the accountability owed to the shareholders. Directors have a personal obligation to disclose a potential conflict of interest to the Chairman of the Board prior to any Board decision related to the matter and, if the Chairman in consultation with legal counsel determines a conflict exists or the perception of a conflict is likely to be significant, to recuse themselves from any discussion or vote related to the matter.[C] Integrity and Conduct

Each director is expected to act with integrity and to adhere to the policies in the Company's Code of Business Conduct and Ethics. Any waiver of the requirements of the Code of Business Conduct and Ethics for any director must be approved by the Board and promptly disclosed on the Company's website.[D] Confidentiality

Each director has an obligation to keep confidential all non-public information that relates to the Company's business. Such information includes, but is not limited to, information regarding the strategy, business, finances and operations of the Company, minutes, reports and materials of the Board and its committees, and other documents identified as confidential by the Company. Additionally, the proceedings and deliberations of the Board and its committees are confidential.[II] EXECUTIVE SESSIONS & INDEPENDENT BOARD LEADERSHIP

The [independent/non-management] directors meet regularly without members of management present in executive session, no less frequently than _____ times per year, and as otherwise determined by such

directors. [If any of the non-management directors do not qualify as an "independent director" as set forth in Section V below, one or more additional executive sessions are held annually, attended only by independent directors.]n1

The executive sessions have such agendas and procedures as determined by the non-management and independent directors. The authority in such sessions to act on behalf of the Company or the Board on any matters requires an express delegation of authority by the Board.

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The evaluation is based on objective criteria including performance of the business, accomplishment of long-term strategic objectives, development of management, etc. The evaluation is used by the Compensation Committee in determining the Chief Executive Officer's compensation.[IV]MANAGEMENT DEVELOPMENT AND SUCCESSION PLANNINGn**

The Chief Executive Officer reports at least annually to the Board on the Company's program for management development and on succession planning, which the Board views as closely-related issues. In its consideration of these issues, it is the policy of the Board to consider issues related to CEO and senior executive selection and performance.

In addition, there is available on a continuing basis, and the Board and CEO periodically discuss, the Chief Executive Officer's recommendation as to a successor in the event of the sudden resignation, retirement or disability of the Chief Executive Officer.[A] Selection of Board Nominees

The Board is responsible for recommending director nominees to shareholders for election. The Board has delegated the screening process to the Nominating and Corporate Governance Committee.n3

The Nominating and Corporate Governance Committee is responsible for reviewing with the Board, on an annual basis, the appropriate skills and characteristics required of directors in the context of the current make up of the Board. This assessment includes issues of judgment, diversity, age, skills (such as an understanding of relevant technologies, international background, etc.), in the context of an assessment of the perceived needs of the Board at that point in time.

The Nominating and Corporate Governance Committee considers recommendations for Board candidates submitted by shareholders using the same criteria it applies to recommendations from the Committee, directors and members of management. Shareholders may submit recommendations by writing to the Committee at _____.

Invitations to serve as a nominee are extended by the Board itself via the Chairman of the Board and the Chairman of the Nominating and Corporate Governance Committee.

[If applicable, include a reference to majority voting and/or director resignation policy]n4 [B] Board Independence n5

The Board has a majority of directors who are not officers or employees of the Company or its subsidiaries and who, in each case, the Board has affirmatively determined lack a "material relationship" with the Company (either directly or as a partner, controlling shareholder or executive officer of an organization that has a material relationship with the Company).

The Board defines a director as lacking a material relationship and therefore will be "independent" (subject to the guidance provided by the Listing Rules of the New York Stock Exchange) if he or she does not have any of the following relationships:

1. within the past three years

(i) is or has been employed by the Company or has an immediate family member who has been an executive officer of the Company;

(ii) has received, or has an immediate family member who has received, more than \$100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);⁶

(iii) has provided significant advisory or consultancy services to the Company, and is, or has an immediate family member who is, affiliated as an executive officer, partner or controlling shareholder with a company or a firm that has provided such significant services (revenue of the greater of 2% of the other company's consolidated gross revenues or \$1 million is considered significant);

(iv) has been a significant customer or supplier of the Company or has been, or has an immediate family member who has been, a partner, controlling shareholder or executive officer of a company or firm that is (revenue of the greater of 2% of the other company's consolidated gross revenues or \$1 million is considered significant);

(v) (a) is, or whose immediate family member is, a current partner of a firm that is the company's internal or external auditor; (b) is a current employee of such a firm; (c) has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance; or (d) was, or has an immediate family member who was (but is no longer) a partner or employee of such a firm and personally worked on the Company's audit;

(vi) has been, or has an immediate family member who has been, employed by another company where any of the Company's current executive officers serve, or within the past three years served, on that company's compensation committee;

For these purposes, "immediate family member" includes a person's spouse, parent, sibling, child, mother- or father-in-law, son- or daughter-in-law or brother- or sister-in-law or anyone (other than domestic employees) who shares a person's home.⁷

2. is an executive officer or chairman of the board of a tax-exempt entity that within the past 12 months received significant contributions from the Company (revenue of the greater of 2% of the entity's consolidated gross revenues or \$1 million is considered significant); and

3. has any other relationships with the Company or with members of senior management that the Board determines to be material.

[C] Commitment and Limits on Other Activities

Directors are expected to limit the number of other boards (excluding non-profits) on which they serve to between _____ and _____, with the lower limit applying to directors who are engaged

full-time in another business. Directors are asked to advise the Chairman of the Board and the Chairman of the Nominating and Corporate Governance Committee in advance of accepting an invitation to serve on another board.[D]
Term and Age Limits

As an alternative to term limits, the Nominating and Corporate Governance Committee formally reviews each director's continuation on the Board at the expiration of the director's term. The Board also has set an age limit of [_____] for directors.[E] Offer of Resignation Upon a Job Change

When a director's principal occupation or business association changes substantially from the position such director held when originally invited to join the Board, the director shall submit to the Chairman of the Nominating and Corporate Governance Committee an offer to resign. The Committee shall review whether it would be appropriate for the director to continue serving on the Board and recommend to the Board whether, in light of the circumstances, the Board should accept the proposed resignation or request that the director continue to serve.n8 [VI]DIRECTOR ORIENTATION AND CONTINUING EDUCATIONn**

The Board has delegated to the Nominating and Corporate Governance Committee the task of designing, with Company management, an appropriate orientation program for new directors that includes background material, meetings with senior management and visits to Company facilities. The Committee also explores, makes available, and designs and provides continuing education opportunities for directors, from time to time.[VII]DIRECTOR COMPENSATION AND STOCK OWNERSHIPn**

The Nominating and Corporate Governance Committee recommends to the Board for approval general principles for determining the form and amount of director compensation and subject to such principles, evaluates annually the status of Board compensation in relation to comparable U.S. companies (in terms of size, business sector, etc.), reporting its findings and recommendations to the Board for approval.n9

[Expand with a brief description of the components of director compensation, general principles for determining the form and amount of director compensation and any policy on stock ownership.]n10 [VIII]BOARD AGENDA, MATERIALS, INFORMATION AND PRESENTATIONS

The Chairman of the Board, with input from senior members of management and the Lead Director, establishes the agenda for each Board meeting. A schedule of agenda subjects to be discussed for the ensuing year is issued at the beginning of each year (to the degree these can be foreseen). Each director is free to suggest the inclusion of item(s) on the agenda.

Information and data that is important to the Board's understanding of the business is distributed in writing to the Board generally five to seven days before the Board meets, although this is not a strict standard, so as to allow for unusual circumstances. Management should ensure that material is as brief as possible while still providing the desired information.

As a general rule, Board meeting time is reserved for discussion. Presentations on specific subjects are forwarded to the directors in advance so that directors may prepare, Board meeting time may be conserved, and discussion time may be focused. However, it is recognized that there may be occasions when an important issue arises without time for written background materials to circulate or the subject matter is not appropriate for written materials, such that more presentation time will be required.[IX]DIRECTOR ACCESS TO SENIOR MANAGERS AND INDEPENDENT ADVISERSn**

Directors have complete access to senior management and to the Board's advisers. Directors are expected to use good judgment to ensure that this contact is not distracting to the business operation of the Company, and that independent advisers are used efficiently.

The Board welcomes regular attendance of senior managers at Board meetings. Should the Chairman and Chief Executive Officer wish to suggest that a senior manager attend on a regular basis, such suggestion is made to the Board for its concurrence. The Board encourages management to bring managers into Board meetings who: (a) can provide additional insight into the items being discussed because of personal involvement in these areas, and/or (b) have future potential such that management believes the Board should have greater exposure to the individual.[X] **BOARD INTERACTION WITH SHAREHOLDERS AND OTHERS/ANNUAL MEETINGS**

Management, and, in particular, the Chief Executive Officer, speaks for the Company with shareholders, investors, employees, customers, suppliers, the press and others. The Chairman of the Board and, in certain circumstances, the Lead Director, speaks for the Board. Individual directors may, from time to time at the request of management, meet or otherwise communicate with various constituencies. If comments from the Board are appropriate, however, they should, in most circumstances, come from the Chairman. Directors are expected to take special care in all communications concerning the Company, in light of confidentiality requirements and laws prohibiting insider trading, tipping and avoidance of selective disclosure.

It is a policy of the Board that all Directors attend the Annual Meeting of Shareholders absent unusual circumstances. (The Company is required to disclose director attendance at such meeting in the Company's next proxy statement or on the Company's website.)(XI)**STANDING BOARD COMMITTEES**

The Board currently has [three] committees: Audit, Compensation and Nominating and Corporate Governance.n11 Membership on such committees is limited to independent directors. The Board retains discretion to form new committees or disband current committees depending upon the circumstances.

The Nominating and Corporate Governance Committee recommends, after consultation with the Chairman of the Board and Chief Executive Officer, and with consideration of the desires of individual directors, the appointment of directors to various committees and the appointment of committee chairmen, for Board approval.[XII]**ANNUAL BOARD AND COMMITTEE PERFORMANCE EVALUATIONS**n**

The Board conducts an annual self-evaluation of its performance and the performance of its committees. The Nominating and Corporate Governance Committee recommends to the Board and its committees the methodology for such evaluations and oversees its execution.[XIII]**COMMUNICATING WITH THE BOARD**

Shareholders are invited to communicate to the Board or its committees by writing to:_____.n12 [XIV]**CORPORATE GOVERNANCE GUIDELINES**

The Nominating and Corporate Governance Committee reviews these Guidelines periodically and recommends amendments to the Board as necessary.

These Guidelines are posted on the Company's website for communication to the Company's shareholders.n13

FOOTNOTES:

(n2)Footnote *. Provisions included throughout this sample in brackets should be conformed to the Company's particular circumstances.

(n3)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n28)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked

with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n4)Footnote 1. For companies listed on the New York Stock Exchange ("NYSE"). On November 23, 2005, the NYSE filed with the SEC proposed rule changes to Section 303A of the NYSE Listed Company Manual concerning the standards for determining director independence and related disclosure requirements (File No. SR-NYSE-2005-81). The SEC has not yet published any of these proposed listing standard amendments for comment, which is a pre-requisite for their approval and effectiveness. As proposed, the rules clarify that the "executive session" meetings that it requires be regularly held may be held among only independent directors (and are not required to also include non-independent, non-management directors, but in the directors' discretion may do so, although at least one such meeting each year should include only independent directors). See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005). Nevertheless, these proposed amendments provide some guidance regarding the NYSE's interpretation of its listing standards and are noted below where relevant.

(n29)Footnote 1. For companies listed on the New York Stock Exchange ("NYSE"). On November 23, 2005, the NYSE filed with the SEC proposed rule changes to Section 303A of the NYSE Listed Company Manual concerning the standards for determining director independence and related disclosure requirements (File No. SR-NYSE-2005-81). The SEC has not yet published any of these proposed listing standard amendments for comment, which is a pre-requisite for their approval and effectiveness. As proposed, the rules clarify that the "executive session" meetings that it requires be regularly held may be held among only independent directors (and are not required to also include non-independent, non-management directors, but in the directors' discretion may do so, although at least one such meeting each year should include only independent directors). See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005). Nevertheless, these proposed amendments provide some guidance regarding the NYSE's interpretation of its listing standards and are noted below where relevant.

(n5)Footnote 2. Nasdaq does not require that a listed company establish a compensation committee. However, CEO and other executive officer compensation must be determined or recommended to the board for approval by a compensation committee that is composed only of independent directors or, if no such committee exists, by a majority of the independent directors. Nasdaq Marketplace Rules, Rule 4350(c)(3), available at <http://www.nasdaq.com/about/LegalCompliance.stm>.

(n30)Footnote 2. Nasdaq does not require that a listed company establish a compensation committee. However, CEO and other executive officer compensation must be determined or recommended to the board for approval by a compensation committee that is composed only of independent directors or, if no such committee exists, by a majority of the independent directors. Nasdaq Marketplace Rules, Rule 4350(c)(3), available at <http://www.nasdaq.com/about/LegalCompliance.stm>.

(n6)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n31)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n13)Footnote 3. Nasdaq does not require that a listed company establish a nominating committee, however, listed companies must adopt a committee charter or by board resolution which (i) establishes a process for the selection by the board of directors of nominees for election by the shareholders and (ii) addresses such other matters relating to director nominations as may be required under the federal securities laws (such as a policy regarding the consideration that will be given to candidates for nomination by the board proposed by securityholders, which policy companies are required to disclose in a proxy statement for the election of directors). Nasdaq Marketplace Rules, Rule 4350(c)(4).

(n38)Footnote 3. Nasdaq does not require that a listed company establish a nominating committee, however, listed companies must adopt a committee charter or by board resolution which (i) establishes a process for the selection by the board of directors of nominees for election by the shareholders and (ii) addresses such other matters relating to director nominations as may be required under the federal securities laws (such as a policy regarding the consideration that will be given to candidates for nomination by the board proposed by securityholders, which policy companies are required to disclose in a proxy statement for the election of directors). Nasdaq Marketplace Rules, Rule 4350(c)(4).

(n14)Footnote 4. This provision is not required to be included in Corporate Governance Guidelines. However, in response to increasing shareholder interest in majority voting for director elections, some companies have adopted a policy (in Corporate Governance Guidelines or as a separate policy) that a director will resign from the board if he or she does not receive a majority of votes cast "for" election ("director resignation"). Note that other options available to companies with respect to implementing a majority voting standard for director elections include: amending its Bylaws to include such a director resignation provision; amending its Bylaws to provide that directors shall be elected by a majority of votes cast (a "majority vote standard"); or amending its Certificate of Incorporation to include a majority vote standard.

(n39)Footnote 4. This provision is not required to be included in Corporate Governance Guidelines. However, in response to increasing shareholder interest in majority voting for director elections, some companies have adopted a policy (in Corporate Governance Guidelines or as a separate policy) that a director will resign from the board if he or she does not receive a majority of votes cast "for" election ("director resignation"). Note that other options available to companies with respect to implementing a majority voting standard for director elections include: amending its Bylaws to include such a director resignation provision; amending its Bylaws to provide that directors shall be elected by a majority of votes cast (a "majority vote standard"); or amending its Certificate of Incorporation to include a majority vote standard.

(n15)Footnote 5. This provision is based on, but goes beyond, the NYSE bright-line standards that define when a director may not be considered independent. A board must make an affirmative determination regarding director independence and in doing so must consider whether relationships not addressed by the bright-line standards nonetheless impair independence. Listed companies must identify which directors are independent in their annual meeting proxy statement or, if they do not file an annual meeting proxy statement, in their annual report. If the board has determined that a director has a relationship with the listed company that is immaterial it must also include in the company's annual meeting proxy statement (or annual report) a specific description of the relationship and the basis for the board's determination that the relationship is not material. NYSE Listed Company Manual, § 303A.02. However, note that the NYSE has proposed a change in its listing standards to clarify the required disclosure regarding director independence. As proposed, listed companies will be required to state with respect to each independent director that he or she has no relationships with the listed company, other than his or her service as a director or shareholder, or has only immaterial relationships. If an immaterial relationship exists, that relationship must be specifically described and the board's basis for determining that such relationship is immaterial, unless it may provide such explanation by applying a customized materiality standard, as described below (including with the qualifications on the use of such standards) simultaneously proposed by the NYSE. See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005). Additionally, the NYSE proposed rule changes note that the board should be aware that concerns regarding directors' independence may be raised when a listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director and that the board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director. See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005).

Nasdaq companies should consider adopting a provision based on, but expanding upon, the Nasdaq independence requirements, for example, along the following lines. Listed companies must identify which directors are independent in their annual meeting proxy statement or, if they do not file an annual meeting proxy statement, in their annual report. (Note that Nasdaq recently amended Rule 4200(a)(15) relating to the standards for determining director independence

and its related interpretive memorandum IM-4200, as well as other, incidental rule amendments (SEC File No. SR-NASDAQ-2006-021 (Oct. 6, 2006)):

The Board has a majority of directors who are not officers or employees of the Company or its subsidiaries and who, in each case, the Board has affirmatively determined has no relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment in carrying out the responsibilities of a director.

The Board shall not consider a director to be independent (subject to the interpretative materials of the Nasdaq Stock Market) if he or she:

- is, or at any time during the past three years was, employed by the Company or by any parent or subsidiary of the Company. (Note that Nasdaq has amended IM-4200 interpreting this provision to clarify that payments to a director to provide his or her services as an interim executive officer for a year or less will not be considered employment constituting a per se bar to a finding of independence, but that the board must nevertheless affirmatively determine that such service and the compensation received therefore would not interfere with his or her ability to exercise independent judgment as a director. Nasdaq Marketplace Rules, IM-4200(a)(15)).
- accepted, or has a family member who accepted, any compensation from the Company or any parent or subsidiary of the Company of more than \$60,000 annually during the current or any of the past three fiscal years, other than director compensation or payments under a tax-qualified retirement plan or other non-discretionary compensation for prior services rendered. (Note that Nasdaq has amended this provision and substituted "compensation" for "payments" and has made conforming changes in the wording of IM-4200 interpreting this provision. This amendment clarifies that payments for personal services or political contributions to a candidate will be considered disqualifying compensation. Nasdaq Marketplace Rules, IM-4200(a)(15)). Also note that on November 16, 2006 Nasdaq proposed amending this provision to increase the \$60,000 standard to \$120,000 consistent with the recently adopted amendments to Item 404 of Regulation S-K. This rule change has not yet been published. See SR-NASDAQ-2006-41).
- The following payments will not be considered: (i) compensation for Board or Board committee service; (ii) payments arising solely from investments in the Company's securities; (iii) compensation paid to a family member who is a non-executive employee of the Company or a parent or subsidiary of the Company; (iv) benefits under a tax-qualified retirement plan or non-discretionary compensation; or (v) loans permitted under Section 13(k) of the Securities Exchange Act of 1934, as amended. (In addition, Nasdaq has amended IM-4200 to provide that non-preferential payments by a listed company or its subsidiaries or affiliates to a director or his or her family members made in the ordinary course of such companies' provision of business services will not pose a per se bar to a finding by the board that the director is independent as long as the payments are non-compensatory in nature. Nasdaq Marketplace Rules, IM-4200(a)(15)).
- is a family member of an individual who is, or at any time during the past three years was, an executive officer of the Company or any parent or subsidiary of the Company.
- is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization that is considered a significant supplier or customer of the listed company (including charitable organizations) to which the Company made, or from which the Company received, payments

for property or services in the current or any of the past three fiscal years that exceed the greater of five percent (5%) of the recipient's consolidated gross revenues for that year or \$200,000.

- Payments (i) arising solely from investments in the Company's securities, or (ii) under non-discretionary charitable contribution matching programs, will not be considered.

- is, or has a family member who is, an executive officer of another entity where, at any time during the past three years, any of the Company's executive officers served on that entity's compensation committee.

- is, or has a family member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.

(n40)Footnote 5. This provision is based on, but goes beyond, the NYSE bright-line standards that define when a director may not be considered independent. A board must make an affirmative determination regarding director independence and in doing so must consider whether relationships not addressed by the bright-line standards nonetheless impair independence. Listed companies must identify which directors are independent in their annual meeting proxy statement or, if they do not file an annual meeting proxy statement, in their annual report. If the board has determined that a director has a relationship with the listed company that is immaterial it must also include in the company's annual meeting proxy statement (or annual report) a specific description of the relationship and the basis for the board's determination that the relationship is not material. NYSE Listed Company Manual, § 303A.02. However, note that the NYSE has proposed a change in its listing standards to clarify the required disclosure regarding director independence. As proposed, listed companies will be required to state with respect to each independent director that he or she has no relationships with the listed company, other than his or her service as a director or shareholder, or has only immaterial relationships. If an immaterial relationship exists, that relationship must be specifically described and the board's basis for determining that such relationship is immaterial, unless it may provide such explanation by applying a customized materiality standard, as described below (including with the qualifications on the use of such standards) simultaneously proposed by the NYSE. See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005). Additionally, the NYSE proposed rule changes note that the board should be aware that concerns regarding directors' independence may be raised when a listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director and that the board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director. See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005).

Nasdaq companies should consider adopting a provision based on, but expanding upon, the Nasdaq independence requirements, for example, along the following lines. Listed companies must identify which directors are independent in their annual meeting proxy statement or, if they do not file an annual meeting proxy statement, in their annual report. (Note that Nasdaq recently amended Rule 4200(a)(15) relating to the standards for determining director independence and its related interpretive memorandum IM-4200, as well as other, incidental rule amendments (SEC File No. SR-NASDAQ-2006-021 (Oct. 6, 2006)):

The Board has a majority of directors who are not officers or employees of the Company or its subsidiaries and who, in each case, the Board has affirmatively determined has no relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment in carrying out the responsibilities of a director.

The Board shall not consider a director to be independent (subject to the interpretative materials of

the Nasdaq Stock Market) if he or she:

- is, or at any time during the past three years was, employed by the Company or by any parent or subsidiary of the Company. (Note that Nasdaq has amended IM-4200 interpreting this provision to clarify that payments to a director to provide his or her services as an interim executive officer for a year or less will not be considered employment constituting a per se bar to a finding of independence, but that the board must nevertheless affirmatively determine that such service and the compensation received therefore would not interfere with his or her ability to exercise independent judgment as a director. Nasdaq Marketplace Rules, IM-4200(a)(15)).

- accepted, or has a family member who accepted, any compensation from the Company or any parent or subsidiary of the Company of more than \$60,000 annually during the current or any of the past three fiscal years, other than director compensation or payments under a tax-qualified retirement plan or other non-discretionary compensation for prior services rendered. (Note that Nasdaq has amended this provision and substituted "compensation" for "payments" and has made conforming changes in the wording of IM-4200 interpreting this provision. This amendment clarifies that payments for personal services or political contributions to a candidate will be considered disqualifying compensation. Nasdaq Marketplace Rules, IM-4200(a)(15)). Also note that on November 16, 2006 Nasdaq proposed amending this provision to increase the \$60,000 standard to \$120,000 consistent with the recently adopted amendments to Item 404 of Regulation S-K. This rule change has not yet been published. See SR-NASDAQ-2006-41).

- The following payments will not be considered: (i) compensation for Board or Board committee service; (ii) payments arising solely from investments in the Company's securities; (iii) compensation paid to a family member who is a non-executive employee of the Company or a parent or subsidiary of the Company; (iv) benefits under a tax-qualified retirement plan or non-discretionary compensation; or (v) loans permitted under Section 13(k) of the Securities Exchange Act of 1934, as amended. (In addition, Nasdaq has amended IM-4200 to provide that non-preferential payments by a listed company or its subsidiaries or affiliates to a director or his or her family members made in the ordinary course of such companies' provision of business services will not pose a per se bar to a finding by the board that the director is independent as long as the payments are non-compensatory in nature. Nasdaq Marketplace Rules, IM-4200(a)(15)).

- is a family member of an individual who is, or at any time during the past three years was, an executive officer of the Company or any parent or subsidiary of the Company.

- is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization that is considered a significant supplier or customer of the listed company (including charitable organizations) to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed the greater of five percent (5%) of the recipient's consolidated gross revenues for that year or \$200,000.

- Payments (i) arising solely from investments in the Company's securities, or (ii) under non-discretionary charitable contribution matching programs, will not be considered.

- is, or has a family member who is, an executive officer of another entity where, at any time during the past three years, any of the Company's executive officers served on that entity's compensation

committee.

■ is, or has a family member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.

(n16)Footnote 6. Compensation received (i) for prior service as an interim Chairman, CEO or other executive officer or (ii) by an immediate family member for service as an employee (other than an executive officer) of the listed company is not considered disqualifying for this purpose.

(n41)Footnote 6. Compensation received (i) for prior service as an interim Chairman, CEO or other executive officer or (ii) by an immediate family member for service as an employee (other than an executive officer) of the listed company is not considered disqualifying for this purpose.

(n17)Footnote 7. The NYSE has proposed amending the definition of "immediate family member" to clarify that it does not include stepchildren who do not share a stepparent's home, or the in-laws of such stepchildren. See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005).

(n42)Footnote 7. The NYSE has proposed amending the definition of "immediate family member" to clarify that it does not include stepchildren who do not share a stepparent's home, or the in-laws of such stepchildren. See SEC File No. SR-NYSE-2005-81 (Nov. 23, 2005).

(n18)Footnote 8. Many companies include a provision in their guidelines and principles requiring each director to tender his or her resignation upon a substantial change in principal occupation or business association, although such a provision is not required. As an alternative, the guidelines and principles could require each director to notify the Chairman of the Nominating and Corporate Governance Committee of any substantial change in principal occupation or business association -- such a provision is also not required.

(n43)Footnote 8. Many companies include a provision in their guidelines and principles requiring each director to tender his or her resignation upon a substantial change in principal occupation or business association, although such a provision is not required. As an alternative, the guidelines and principles could require each director to notify the Chairman of the Nominating and Corporate Governance Committee of any substantial change in principal occupation or business association -- such a provision is also not required.

(n19)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n44)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n20)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n45)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n21)Footnote 9. As an alternative, the Compensation Committee may address this responsibility given its role with

respect to oversight and disclosure of compensation.

(n46)Footnote 9. As an alternative, the Compensation Committee may address this responsibility given its role with respect to oversight and disclosure of compensation.

(n22)Footnote 10. The NYSE recommends that when determining director compensation, the board should be aware that questions as to the directors' independence may be raised when directors' fees and emoluments exceed what is customary and that similar concerns may be raised when the listed company makes substantial contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. Additionally, the board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director. NYSE Listed Company Manual, § 303A.09.

(n47)Footnote 10. The NYSE recommends that when determining director compensation, the board should be aware that questions as to the directors' independence may be raised when directors' fees and emoluments exceed what is customary and that similar concerns may be raised when the listed company makes substantial contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. Additionally, the board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director. NYSE Listed Company Manual, § 303A.09.

(n23)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n48)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n24)Footnote 11. Nasdaq only requires an Audit Committee. Although Nasdaq does not require listed companies to have nominating and compensation committees, as noted above, companies must have (i) director nominees selected or recommended for the board's selection by an independent nominating committee or by a majority of the independent directors and (ii) CEO and executive officer compensation determined or recommended to the board for approval by an independent compensation committee or by a majority of the independent directors.

(n49)Footnote 11. Nasdaq only requires an Audit Committee. Although Nasdaq does not require listed companies to have nominating and compensation committees, as noted above, companies must have (i) director nominees selected or recommended for the board's selection by an independent nominating committee or by a majority of the independent directors and (ii) CEO and executive officer compensation determined or recommended to the board for approval by an independent compensation committee or by a majority of the independent directors.

(n25)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n50)Footnote **. The New York Stock Exchange requires listed U.S. companies to address the topics marked with an asterisk in the Company's Corporate Governance Guidelines & Principles. New York Stock Exchange Listed Company Manual § 303A.09.

(n26)Footnote 12. Companies listed on the NYSE are required to disclose information about how interested parties can communicate with the director presiding at the executive sessions or the non-management directors as a group. NYSE Listed Company Manual, § 303A.03.

(n51)Footnote 12. Companies listed on the NYSE are required to disclose information about how interested parties can communicate with the director presiding at the executive sessions or the non-management directors as a group. NYSE Listed Company Manual, § 303A.03.

(n27)Footnote 13. NYSE companies are required to have and maintain a publicly accessible website and such website must include a printable version of the listed company's Corporate Governance Guidelines. NYSE Listed Company Manual, § 303A.14. The company must also state in its annual proxy statement (or, if the company does not file an annual proxy statement, in the company's annual report) that its Corporate Governance Guidelines are available on the company's website. NYSE Listed Company Manual, § 303A.09.

(n52)Footnote 13. NYSE companies are required to have and maintain a publicly accessible website and such website must include a printable version of the listed company's Corporate Governance Guidelines. NYSE Listed Company Manual, § 303A.14. The company must also state in its annual proxy statement (or, if the company does not file an annual proxy statement, in the company's annual report) that its Corporate Governance Guidelines are available on the company's website. NYSE Listed Company Manual, § 303A.09.



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Appendix 6-B Sample Board & Board Committee Self-Evaluation Form

1-6-B Corporate Governance: Law and Practice Appendix 6-B.syn

§ 6-B.syn Synopsis to Appendix 6-B: Sample Board & Board Committee Self-Evaluation Form

[6-B] Sample Board & Board Committee Self-Evaluation Form



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Appendix 6-B Sample Board & Board Committee Self-Evaluation Form

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[6-B] Sample Board & Board Committee Self-Evaluation Form

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The following sample Board and Board Committee Self-Evaluation Form is intended to comport with corporate governance listing standards of the New York Stock Exchange and generally accepted practices for boards of directors of publicly-traded U.S. companies.

The New York Stock Exchange's listing standards require that a listed company have a set of corporate governance guidelines and principles that address, among other things, board evaluation. The New York Stock Exchange's listing standards also require that the key committee charters provide for annual evaluations of committee operations. The Nasdaq listing standards do not require board or committee evaluations, although many Nasdaq companies perform such evaluations as a "good governance" practice. Note that PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("AS2") (available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf) now requires - and, if adopted, the PCAOB's proposed auditing standard AS2 which would supersede current AS2, will require - the independent auditor to evaluate - as part of its broader evaluation of the control environment - the effectiveness of the audit committee's oversight of the financial reporting process and related internal controls. As part of their own evaluation, many independent auditors are inquiring into whether the board has evaluated the audit committee and found it to be effective. Therefore, at minimum, Nasdaq companies should consider evaluating the effectiveness of the audit committee, and all public company boards should pay special attention to such evaluation.

Important Practice Pointer: *There are no specific requirements concerning the content of board and committee evaluations nor any requirement that such evaluations be in writing. Please note that **completed evaluation forms may be discoverable in litigation**. Therefore, some boards are opting for paperless facilitated board and committee discussions as the means of evaluation. (The questions on the attached form can be used as a guide for such facilitated discussions.) Even when written forms are used, they are typically relied on to collect director viewpoints for an oral report that is given to the board on the results - as an opportunity to engage the full board in a discussion of board performance. A board may wish to consider putting in place a policy that the executed forms not be retained once the information is reviewed. (Document retention policies should be reviewed and limits on routine document destruction in the context of an investigation or institution of a lawsuit considered.) An argument can be made for attorney-client communication protection attaching to the completed evaluation forms if they are designed to provide input to counsel,*

who is advising the board on efforts to improve governance processes. **However, the strength of this argument has not been tested, and it is therefore uncertain whether a court will protect from discovery evaluation materials on these grounds.** Nonetheless, should a board or board committee choose to use written evaluation forms to elicit feedback, it may wish to have counsel involved to collect the information, report back to the board and/or committee and serve as the facilitator for board discussion. In such case, consider including a "privileged and confidential; attorney-client communication" legend on each evaluation form, along with a statement to the effect that:

"This form is intended for the communication of information to legal counsel, to enable counsel to advise the Board in the Board's continuous efforts to improve corporate governance."

[Name of Company]

Board and Board Committee Self-Evaluation Form

This form is intended for the communication of information to legal counsel, to enable counsel to advise the Board in the Board's continuous efforts to improve corporate governance.

Please respond to the following questions, on a scale of:

* 1 (room for improvement), to

* 5 (area of considerable strength).

Please provide written comments throughout, including suggestions for improving board and committee structure and process. Your individual responses will be kept confidential, and will be reported back to the Board only in a composite that provides anonymity.

I. THE BOARD OF DIRECTORS

A. Board Size and Composition

- | | | | | | | |
|----|--|---|---|---|---|---|
| 1. | Is the Board the right size? (If not, what size should it be?) | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 2. | Does the Board's composition reflect an appropriate proportion of independent, non-executive and executive directors? (If not, how should the proportions be adjusted?) | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 3. | Does the Board's composition reflect an appropriate mix of skills, experience, backgrounds, and diversity in relation to the needs of the Company? (What characteristics should be represented more/less?) | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 4. | Does the Board make appropriate use of the skills and experience of its members? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 5. | Is each director contributing to the work of the Board in an effective manner? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |

B. Board Information & Agenda

- | | | | | | | |
|----|--|---|---|---|---|---|
| 6. | Is the Board actively engaged with management in identify- | 1 | 2 | 3 | 4 | 5 |
|----|--|---|---|---|---|---|

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ing, prioritizing and scheduling issues for Board review and discussion?

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 7. | Is the Board actively engaged in identifying and communicating to management the Board's information needs, including information about the competitive environment, risk identification and assessment, and performance benchmarks? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 8. | Do Board members receive timely and accurate minutes, advance written agendas and meeting notices? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 9. | Do Board members receive clear, concise and relevant background materials to prepare in advance for meetings? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 10. | Do Board members stay abreast of issues and trends affecting the company, and use this information to assess and guide the company's performance both year-to-year and in the long term? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 11. | Do Board members devote time to learn about the company's business and understand it well enough to provide critical oversight? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 12. | Does the Board regularly monitor company performance with industry comparative data? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 13. | Is the majority of Board meeting time reserved for Board discussion and consideration rather than management presentations? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 14. | Do Board members have sufficient access to officers and other members of the management team outside of Board meetings? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 15. | Are new Board members provided with an appropriate orientation and other relevant information about the company and the Board? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 16. | Are directors kept well informed of important company matters between Board meetings? | 1 | 2 | 3 | 4 | 5 |
| | Comments: | | | | | |
| 17. | Does the Board devote sufficient attention to: | | | | | |
| | (a) the company's financial statements and processes? | 1 | 2 | 3 | 4 | 5 |
| | (b) the company's annual capital and operating budgets and plans? | 1 | 2 | 3 | 4 | 5 |

1-6-B Corporate Governance: Law and Practice [6-B]

	(c) the company's long-term strategic plans and planning process?	1	2	3	4	5
	(d) the company's standards of governance and conduct?	1	2	3	4	5
	(e) international operations and developments?	1	2	3	4	5
	(f) technological developments?	1	2	3	4	5
	(g) legal and regulatory developments and compliance?	1	2	3	4	5
	(h) management development and succession?	1	2	3	4	5
	(i) periodic review of major completed transactions (integration and shareholder value creation)?	1	2	3	4	5
C.	Accountability					
18.	Has the Board developed with management a common understanding of the company's beliefs, values and philosophy, and is this understanding reflected in the company's mission, its strategic and business plans and key deliberations throughout the year? Comments:	1	2	3	4	5
19.	Does the Board regularly monitor performance against the strategic and business plans? Comments:	1	2	3	4	5
20.	Does the Board adequately consider shareholder value and the protection of shareholder interests in its decision-making? Comments:	1	2	3	4	5
21.	Are Board meetings conducted in a manner that ensures open communication, meaningful participation and timely resolution of issues? Comments:	1	2	3	4	5
22.	Does the Board encourage/ensure an open line of communication:					
	(a) Between the Board and senior management?	1	2	3	4	5
	(b) Between Board members? Comments:	1	2	3	4	5
23.	Are Board goals, expectations, and concerns openly, honestly and constructively communicated to the CEO? Comments:	1	2	3	4	5
24.	Does the Board understand and respect the difference between the Board's role and the CEO/senior management's role? Comments:	1	2	3	4	5
25.	Is the Board regularly and actively engaged in evaluating the performance of the CEO? Comments:	1	2	3	4	5
26.	Does the Board support the CEO/senior management to act realistically, appropriately and responsibly, while holding	1	2	3	4	5

the CEO/senior management accountable for operating results?

Comments:

D. Standards of Conduct

27. Are directors prepared for Board meetings? 1 2 3 4 5

Comments:

28. Do directors ask appropriate questions of management? 1 2 3 4 5

Comments:

29. Do directors and senior management adequately disclose personal interests in matters subject to Board review and abstain from voting where appropriate? 1 2 3 4 5

Comments:

30. Does the Board deal appropriately with conflicts of interest? 1 2 3 4 5

Comments:

E. Meeting Schedule

31. Are Board meetings held at an appropriate time of day? 1 2 3 4 5

Comments:

32. Is the length of Board meetings appropriate? 1 2 3 4 5

Comments:

33. Is the number of Board meetings appropriate? (If not, what number would be optimal?) 1 2 3 4 5

Comments:

II. BOARD COMMITTEES

A. Generally

34. Does the current committee structure (and committee responsibilities as set forth in charters) contribute to Board efficiency and effectiveness? 1 2 3 4 5

Comments:

35. Are the responsibilities of the committees well defined? 1 2 3 4 5

Comments:

36. Are all Board members kept well informed of the deliberations of each committee? 1 2 3 4 5

Comments:

37. Does the Board rely appropriately on the work and the recommendations of the committees? 1 2 3 4 5

Comments:

38. Is the board's method for determining committee membership and leadership appropriate? 1 2 3 4 5

Comments:

39. Is the Audit Committee effective in fulfilling its responsibilities? [You may wish to review and consider the questions set forth in Section B, below.] 1 2 3 4 5

Comments:

40. Is the Compensation Committee effective in fulfilling its re- 1 2 3 4 5

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responsibilities? [You may wish to review and consider the questions set forth in Section C, below.]

Comments:

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 41. | Is the Nominating & Corporate Governance Committee effective in fulfilling its responsibilities? [You may wish to review and consider the questions set forth in Section D, below.] | 1 | 2 | 3 | 4 | 5 |
|-----|---|---|---|---|---|---|

Comments:

B. Audit Committee n1

(To be answered by Audit Committee Members concerning that Committee's performance.)

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 42. | Is the Audit Committee fulfilling the duties set forth in its charter? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 43. | Are Audit Committee meetings efficient and productive? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 44. | Does the Audit Committee hold an adequate number of meetings during the year? | 1 | 2 | 3 | 4 | 5 |
|-----|---|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 45. | Is the length of Audit Committee meetings appropriate? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 46. | Are Audit Committee agendas set and prioritized to assist the Committee to function effectively? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 47. | Do Committee members have adequate input into the preparation of agendas? | 1 | 2 | 3 | 4 | 5 |
|-----|---|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 48. | Do Committee members receive adequate background information prior to meetings? | 1 | 2 | 3 | 4 | 5 |
|-----|---|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 49. | Is meeting time appropriately allocated between management presentation and Committee discussion, so as to allow adequate opportunity for deliberation? | 1 | 2 | 3 | 4 | 5 |
|-----|---|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 50. | Are meetings conducted in a manner and on a schedule that ensures open communication and meaningful participation? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 51. | Does the Committee reach timely resolution of issues? | 1 | 2 | 3 | 4 | 5 |
|-----|---|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 52. | Does the Committee report on its work and recommendations to the Board in a timely and effective manner? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

- | | | | | | | |
|-----|--|---|---|---|---|---|
| 53. | Is the Committee's leadership effective? | 1 | 2 | 3 | 4 | 5 |
|-----|--|---|---|---|---|---|

Comments:

C. Compensation Committee

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(To be answered by Compensation Committee members concerning that Committee's performance)

- | | | | | | | |
|-----|---|---|---|---|---|---|
| 54. | Is the Compensation Committee fulfilling the duties set forth in its charter?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 55. | Are Compensation Committee meetings efficient and productive?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 56. | Does the Committee hold an adequate number of meetings during the year?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 57. | Is the length of Committee meetings appropriate?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 58. | Are Committee agendas set and prioritized to assist the Committee to function effectively?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 59. | Do Committee members have adequate input into the preparation of agendas?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 60. | Do Committee members receive adequate background information prior to meetings?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 61. | Is meeting time appropriately allocated between management presentation and Committee discussion so as to allow adequate opportunity for deliberation?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 62. | Are meetings conducted in a manner and on a schedule that ensures open communication and meaningful participation?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 63. | Does the Committee reach timely resolution of issues?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 64. | Does the Committee report on its work and recommendations to the Board in a timely and effective manner?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 65. | Is the Committee's leadership effective?
Comments: | 1 | 2 | 3 | 4 | 5 |
| D. | Nominating and Corporate Governance Committee
(To be answered by Nominating and Corporate Governance Committee members concerning that Committee's performance) | | | | | |
| 66. | Is the Nominating and Corporate Governance Committee fulfilling the duties set forth in its charter?
Comments: | 1 | 2 | 3 | 4 | 5 |
| 67. | Are Nominating and Corporate Governance Committee meetings efficient and productive? | 1 | 2 | 3 | 4 | 5 |

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	Comments:					
68.	Does the Committee hold an adequate number of meetings during the year?	1	2	3	4	5
	Comments:					
69.	Is the length of Committee meetings appropriate?	1	2	3	4	5
	Comments:					
70.	Are Committee agendas set and prioritized to assist the Committee to function effectively?	1	2	3	4	5
	Comments:					
71.	Do Committee members have adequate input into the preparation of agendas?	1	2	3	4	5
	Comments:					
72.	Do Committee members receive adequate background information prior to meetings?	1	2	3	4	5
	Comments:					
73.	Is meeting time appropriately allocated between management presentation and Committee discussion, so as to allow adequate opportunity for deliberation?	1	2	3	4	5
	Comments:					
74.	Are meetings conducted in a manner and on a schedule that ensures open communication and meaningful participation?	1	2	3	4	5
	Comments:					
75.	Does the Committee reach timely resolution of issues?	1	2	3	4	5
	Comments:					
76.	Does the Committee report on its work and recommendations to the Board in a timely and effective manner?	1	2	3	4	5
	Comments:					
77.	Is the Committee's leadership effective?	1	2	3	4	5
	Comments:					

Additional Considerations for Audit Committee Evaluationn2**Organization**

1. Does the Audit Committee charter clearly set forth the nature and scope of committee responsibilities?
2. Has the charter been approved by the Committee and the full Board?
3. Does the Committee's composition meet all regulatory requirements?
4. Was the Board actively involved in considering Audit Committee composition, including the designation of the "Audit Committee financial expert"?
5. Do all members actively participate and contribute to the work of the Committee in an effective manner?

6. Does the Committee exhibit in its actions independence from management, ethical behavior, and concern for the best interests of shareholders?
7. Do meeting packages include the right information and are they received with enough lead time to provide the basis for meaningful discussion?
8. Are meetings well organized, efficient, and effective? Do they occur often enough and are they of sufficient length to allow discussion of relevant issues consistent with the Committee's responsibilities?
9. Are members open, honest, and effective in their communication with management, internal and external auditors, and each other?
10. Does the Committee have access to appropriate internal and external resources?
11. Do the minutes and reports to the full Board reflect the significant activities, actions, and recommendations of the Committee?
12. Is the Committee Chair's leadership effective?

Audit Committee Agenda Setting and Oversight of the Financial Reporting Process

1. Does the Committee help establish the appropriate "tone at the top," including an insistence on integrity and accuracy in financial reporting?
2. Has the Committee achieved the right balance of providing effective oversight, without infringing on management's responsibility?
3. Has the company devoted appropriate internal (and external) resources to ensuring the adequacy of its financial reporting process?
4. Does the Committee set clear expectations and provide feedback concerning the competency of the company's CFO and senior financial management staff?
5. Do the Committee's agenda and deliberations reflect ongoing and appropriate consideration of the company's financial reporting risks and related internal controls?
6. Is the Committee's agenda-setting process thorough and led by the Committee Chair?
7. Does the Committee engage in meaningful discussion and consideration of the company's external financial reporting (including the annual report, quarterly financial filings, and press releases)?
8. Does the Committee review and provide effective oversight concerning related person transactions, including the disclosure of such transactions in the proxy statement and/or financial reports?
9. Is the Committee actively engaged in providing oversight of "whistleblower" procedures? (What involvement does the Committee have in the "whistleblower" communication process?)

Oversight of Audit Processes

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1. Do the Committee's actions demonstrate that it takes direct responsibility for the appointment, compensation, and oversight of the work of the independent auditor?
2. Does the Committee actively consider the audit plan and results of the independent audit?
3. Is the pre-approval process over non-audit services to be provided by the independent auditor effective; is it designed to reinforce the auditor's independence?
4. Is there an effective procedure in place for the evaluation of the independent auditor's qualifications, performance, and independence?
5. Is appropriate consideration given to the management letter and other communications from the independent auditor?
6. Do the internal audit reporting lines and interaction with the Committee foster an environment in which issues that might involve management are likely to be brought to the attention of the Committee? (How does the Committee demonstrate and reinforce its direct responsibility for oversight of the independent auditor?)
7. Does the Committee give appropriate consideration to the internal audit department's plan, resources, and ability?
8. Does the Committee give appropriate consideration to the internal audit department's reports, management's response, and improvement actions?
9. Do the Committee's executive sessions with the internal and independent auditor result in candid discussion of relevant issues?

Continuous Improvement

1. Does the Committee provide effective orientation for new members?
2. Does the Committee provide and encourage ongoing education for members?
3. Is this evaluation process effective?
4. Do any and all matters identified that require follow-through get resolved?

Overall Evaluation

What is your overall assessment of the performance of the Audit Committee?

FOOTNOTES:

(n53)Footnote 1. See Additional Considerations for Audit Committee Evaluation attached.

(n54)Footnote 2. Adapted from materials prepared by KPMG's Audit Committee Institute, "An Approach to Effective Audit Committee Evaluation," April 2003, www.kpmg.com/aci/docs/selfevaluation.pdf.



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice 7.syn

AUTHOR: Robert B. Lamm

§ 7.syn Synopsis to Chapter 7: BOARD STRUCTURE AND PROCESSES

§ 7.01 Board Structure

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[2] Attributes of Board Structure

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[b] Membership and Composition

[c] Tenure and Retirement Age

[d] Meetings

[3] Board Leadership

[4] Use of Committees

[a] Factors Influencing Committee Types, Structure and Responsibilities

[b] Types of Committees

[c] Composition of Committees

[d] Formation and Operation of Committees

§ 7.02 Board Delegation of Authority

§ 7.03 Evaluation of the CEO and Senior Management

[1] Who Conducts the Evaluation?

[2] The Evaluation Process

§ 7.04 Board, Committee and Director Evaluations

§ 7.05 Succession Planning

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§ 7.07 Information Flow to the Board

§ 7.08 Executive Sessions

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Robert B. Lamm



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.01

AUTHOR: Robert B. Lamm

§ 7.01 Board Structure

[1] Legal Framework

State corporate law vests the ultimate power and duty to manage the business of the corporation with the board of directorsⁿ¹ and permits the board to delegate tasks and functions to committees.ⁿ² Boards generally have had a great deal of flexibility to organize their structure and operation in a manner that each concluded best enabled it to fulfill its legal duties and responsibilities. In the wake of the corporate scandals that began with Enron, this flexibility has been curtailed. For example, the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "Sarbanes-Oxley")ⁿ³ controls the composition and certain responsibilities of audit committees, and the corporate governance listing standards of the New York Stock Exchange ("NYSE")ⁿ⁴ and NASDAQⁿ⁵ mandate audit, compensation and nominating/corporate governance committees, as well as certain board processes, such as board and committee self-evaluation. Thus, while boards can still choose the means by which they fulfill these various mandates, their structures and operations are more constrained than in the past.

The financial crisis that began in 2007-2008 resulted in renewed efforts to control the structure of boards of directors. For example, the "Shareholder *Bill of Rights* Act", legislation introduced by New York Senator Schumer and Washington Senator Cantwell in May 2009, would effectively require that boards of directors of public companies form committees to assess and manage risks.

[2] Attributes of Board Structure

[a] Size

State corporate law generally does not specify the size of the board, although some jurisdictions require a minimum number of directors.ⁿ⁶ Most state laws leave it to the corporation to specify the size of the board in its certificate of incorporation or its by laws, or in accordance with procedures set out in the certificate of incorporation or bylaws.ⁿ⁷ Common practice is to define the minimum and maximum number of directors in the company's certificate of incorporation and provide that the exact number is to be set in the bylaws or by resolution of the board.ⁿ⁸

The size of boards of directors tends to vary from industry to industry and corporation to corporation.ⁿ⁹ The Business

Roundtable suggests that "[i]n determining board size, directors should consider the nature, size, and complexity of the corporation as well as its stage of development."¹⁰ Other factors that may influence board size include: "the need to maintain a strong community presence, to establish or maintain relationships with large shareholders or other constituencies, or to respond to factors particular to the corporation or the industry in which the corporation operates."¹¹ For example, financial services companies and those operating complex businesses have traditionally had larger boards, with as many as fifteen or more members,¹² which may make it less likely for them to work cohesively.¹³ In fact, there has been a trend toward smaller boards over the last decade, with board size stabilizing at 10.8 directors in recent years.¹⁴ The emerging consensus is that smaller boards (7 to 11 members) function more effectively except for the very largest and most complex corporations.¹⁵

[b] Membership and Composition

The NYSE and NASDAQ¹⁶ corporate governance listing standards require that listed companies have a majority of independent directors, unless they are "controlled companies" (in which a majority of the voting power is held by a person or group).¹⁷ The Business Roundtable goes further and suggests that, as a matter of best practice, a substantial majority of directors of a publicly owned company should be independent of management.¹⁸ In fact, 2007 data indicates that most larger companies meet this standard.¹⁹

The standards for determining a particular director's independence also are governed by the NYSE and NASDAQ listing standards, which contain specific definitions of director independence.²⁰ It is not sufficient, however, for a board of directors to consider only the relationships set forth in these definitions. Both the NYSE and NASDAQ require a company's board of directors to determine that the individuals have no relationship which would, in the judgment of the board, interfere with the exercise of independent judgment, such as a director's service on the board of a charitable organization to which the company makes contributions.²¹ The NYSE requires that the independent directors be identified and that the company disclose the basis for the determination that any relationship between a director and the company is not material. Alternatively, the board may avoid having to disclose the basis for the determination by adopting--and disclosing--"categorical" independence standards and disclosing that the directors meet these standards. Many companies have opted for this approach, although in most cases the categorical standards are substantially the same as the NYSE's definitions.²² In addition, as part of the executive compensation/related party disclosure rules adopted by the SEC in 2006, companies must disclose the relationships, by category or type, that the board considered in finding a director to be independent, even if such relationships are immaterial.²³ Independence determinations generally are made after the solicitation of relevant information from directors via questionnaires, consideration of such information by the nominating/corporate governance committee and a recommendation by this committee to the full board.²⁴

In light of the interest in director independence, some commentators have expressed concern that insufficient attention is being paid to the importance of a director's knowledge concerning the company's business.²⁵ Olson and Adams, for example, assert that "boards of directors may well be more effective when they include inside directors or other non-independent directors who have a business relationship with the corporation, because such directors have a more extensive understanding of the corporation and its business."²⁶ Similarly, Carter and Lorsch believe that a good board requires some members with experience relevant to the industry.²⁷

In addition to considering industry experience, the board and, in particular its nominating/corporate governance committee, should think strategically about the composition of the board on an ongoing basis.²⁸ "The key goal in selecting directors is to build a mix of experience that is appropriate to the board's needs."²⁹ For example, if the company is engaged in geographical expansion, the board may want to add directors who are familiar with the areas in which the company plans to expand. Additionally, there has been increased focus on the need for a board to reflect gender and ethnic diversity. In this regard, the Business Roundtable suggests that "[t]he [corporate governance] committee should consider candidates from a range of backgrounds. Diversity in gender, age, race and perspective all are appropriate considerations. In recent years, corporations have drawn directors from a variety of sources, including

the public sector, educational and charitable institutions, and senior management, in addition to current and former CEOs.ⁿ³⁰ These factors have been reported to have led to increased use of search firms to assist companies to find the most qualified directors. The trend to use search firms may also be growing due to other factors, such as concerns regarding potential liability for board service and the reportedly increasing reluctance of active CEOs to serve on other companies' boards.ⁿ³¹

[c] Tenure and Retirement Age

Board term limits restrict directors from serving more than a certain number of terms. For example, a director at a company with a staggered board (*i.e.*, a three-year term) might be limited to three or four such terms. While there are some advocates of term limits,ⁿ³² commentators generally oppose such limits for several reasons. First, it takes independent directors a long time to learn about their company. Second, term limits can be used as an excuse for not conducting meaningful performance evaluations of directors.ⁿ³³ If, however, there has been no movement on the board for several years, Carter and Lorsch suggest that it may be appropriate to ask a director to leave, as "[b]oards need to be refreshed with new ideas from new blood on a regular basis."ⁿ³⁴ Others, including some institutional owners in the United Kingdom, go further and suggest that after a certain number of years (10-12) a director should no longer be considered independent.ⁿ³⁵

Many boards of directors do have retirement ages, generally ranging from 70 to 72, with some as high as 75.ⁿ³⁶ A clear retirement age provides a means to assure that directors who have long left their careers behind them can be eased off the board and ensures that new blood will be added to the board on an ongoing basis. Another way that some companies achieve this goal is by requiring that directors who change their principal employment offer their resignation to, or at least notify, the nominating/corporate governance committee for its chair, so that the committee can determine whether the director's continued service on the board is appropriate. Some companies also provide that the board can waive the retirement age in appropriate cases to permit directors to remain on the board.ⁿ³⁷

[d] Meetings

There are no statutory, SEC or listing standard requirements with respect to the number of meetings that a board must have on an annual basis, although the NYSE and NASDAQ do require executive sessions of the non-management directors at least once per year.ⁿ³⁸ The number of meetings a board will find necessary varies with the company's size, complexity and culture.ⁿ³⁹ Some boards prefer frequent, shorter meetings, while others, especially those where directors are geographically scattered, may prefer longer, less frequent meetings. The advent of improved technology for telephonic videoconference and virtual board meetings is also impacting practice (although some commentators stress the need for in-person meetings to facilitate discussions--which can be awkward when conducted by teleconference--or to consider body language⁴⁰). Generally, however, "most public company boards schedule six to eight regular meetings each year and hold special meetings as needed."ⁿ⁴¹

[3] Board Leadership

In the United States, most corporations traditionally have had a single individual serving as CEO and Chairman of the Board.ⁿ⁴² While some companies have found it useful to split the roles in times of crisis, as General Motors did early in the 1990s, or to provide continuity of leadership in times of transition, as some companies do when they appoint a new CEO, the general practice has been to combine the roles. The traditional view has been that the combined CEO/Chairman serves as a bridge between management and the board, ensuring that both act with a common purpose.ⁿ⁴³ Moreover, a 2004 study by Booz Allen Hamilton found no evidence that separating the roles of Chairman and CEO benefits stockholders.ⁿ⁴⁴ In fact, the study found that stockholder returns and net income growth were lower at companies that split the position. Nonetheless, more U.S. companies have been separating the positions. In some cases, this action has been taken in response to increased stockholder pressure; in others, it has followed an unexpected termination of the CEO or the resolution of a crisis involving management integrity.

In response to pressure from institutional investors and corporate governance groups calling for a separation of the CEO and Chairman, companies and others developed the concept of a "lead" or "presiding" director to assist the board in overseeing management.ⁿ⁴⁵ Many companies have, in fact, appointed lead or presiding directors,ⁿ⁴⁶ in part to address the NYSE listing requirement that companies appoint a director to preside over the required regular executive sessions of the non-management directors and disclose this person in the proxy statement.ⁿ⁴⁷

Until recently, institutional owners generally accepted the use of a lead or presiding director (subject to concerns about the functions and responsibilities of lead or presiding directors discussed below) and did not appear to prefer or distinguish between the title of "lead" or "presiding" director, although some boards have had strong feelings on the matter. However, in response to the financial crisis that began in 2007-2008, demands by institutional investors and others for separating the positions of Chairman of the Board and CEO have substantially increased, as discussed below, notwithstanding the designation of a lead or presiding director.

There is no uniformity as to the functions that lead or presiding directors perform. Beyond presiding at executive sessions, other responsibilities that lead directors undertake vary greatly but often include: (1) advising the CEO/Chairman on meeting schedules; (2) providing the CEO/Chairman with input on agendas for meetings; (3) chairing executive sessions; (4) overseeing the flow of information to the board; and (5) serving as the principal liaison among the independent directors, between independent directors and the CEO/Chairman, or between directors and other members of management (for example, reinforcing advice from the general counsel that directors should refrain from taking notes at meetings). A lead director also may play a key role in organizing performance evaluations of the CEO and the board and may lead the board in crisis situations.ⁿ⁴⁸ (In some cases, the lead director has taken on the position of non-executive chairman when the CEO who has also served as chairman leaves the company voluntarily or otherwise.) Despite the potential benefits of a flexible approach to the functions of a lead or presiding director, institutional owners and others have urged that the lead or presiding director have a standard "package" of responsibilities, possibly to reduce the likelihood that a company will designate such a director but give that director such limited powers as to make the position ineffectual.

For example, in discussing its voting policy on stockholder proposals to separate the positions of Chairman and CEO, RiskMetrics Group (formerly known as Institutional Shareholder Services) has stated that the duties of a lead or presiding director should, "[a]t include , but are not limited to, the following:

- presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors;
- serves as liaison between the chairman and the independent directors;
- approves information sent to the board;
- approves meeting agendas for the board;
- approves meetings schedules to assure that there is sufficient time for discussion of all agenda items;
- has the authority to call meetings of the independent directors; and
- if requested by major shareholders, ensures that he is available for consultation and direct communication."ⁿ⁴⁹

In any event, it can be useful to create a job description for the position to avoid confusion and to include that description in the company's corporate governance principles or guidelines.

As previously noted, the financial crisis that began in 2007-2008 resulted in increased demands for separating the positions of Chairman of the Board and CEO. These demands have generally been in the form of shareholder proposals, including proposals to adopt mandatory by-law amendments to separate the positions. In the 2009 proxy season, these proposals fared better than in previous years, (including a mandatory by-law amendment proposal submitted to Bank of America, which separated the offices almost immediately after the voting results became available⁵⁰). In addition, the "Shareholder Bill of Rights Act" legislation introduced by New York Senator Schumer and Washington Senator Cantwell in May 2009 in response to the ongoing financial crisis would require that all public companies separate the positions.

In addition, the Chairman of the Securities and Exchange Commission ("SEC") has indicated that the SEC will be considering whether companies should provide disclosure as to their reasons for choosing their particular leadership structure, regardless of whether the structure includes an independent chairman, a non-independent chairman or a combined CEO/chairman.⁵¹

[4] Use of Committees

For many years, boards of directors have used committees to address key matters in depth. The use of committees, and the board's ability to rely upon the recommendations and other actions of its committees, are expressly sanctioned by state corporation law. For example, the Delaware General Corporation Law permits a board to create one or more committees and, except for specific matters on which only the board may act, provides that any committee may exercise the full power and authority of the board.⁵² In addition, Delaware law expressly permits a director to rely upon "information, opinions, reports or statements presented ... by committees of the board of directors," so long as the director reasonably believes that the committee is acting within its area of competence and has been selected with reasonable care.⁵³ In other words, if a board acts reasonably in selecting a committee and reasonably believes that the committee is acting properly and knowledgeably, the board should be protected in relying on the committee.⁵⁴

[a] Factors Influencing Committee Types, Structure and Responsibilities

The types and structure of board committees vary from company to company, depending upon a number of factors. These include the company's business, legal and regulatory requirements applicable to the business, the types of transactions in which the company routinely engages, the size of the board and the expertise of its members. The Sarbanes-Oxley Act and rules adopted by the Securities and Exchange Commission ("SEC") under Sarbanes-Oxley govern the composition and responsibilities of the audit committee, and the corporate governance listing standards of the market on which the company's securities are traded control the formation and responsibilities of other board committees, as well as those of the audit committee. Finally, the concerns of institutional investors and others in the governance community also affect the make-up and responsibilities of board committees.

The nature of the company's business, coupled with any regulatory requirements applicable to its business, has a significant impact upon the types and structure of its board committees. For example, a company engaged in a technologically-oriented business may find it necessary or appropriate to form a technology or similar committee to review and recommend to the board appropriate technical goals and projects; this type of committee would ordinarily be comprised of directors who have a higher level of relevant technical expertise than other directors. (An alternative used by some technology companies is the formation of an "advisory" committee, comprised of individuals who may not be directors or officers, with varying degrees of interaction with the board.) Similarly, some companies--such as those in highly regulated industries--may deem it desirable to designate a compliance or similar committee.

The types of transactions in which a company routinely engages also affect the types and structure of its board committees. A company that accesses the capital markets infrequently may well find it desirable to keep its full board of directors informed of the progress and terms (including pricing) of an offering, and to have the offering approved by the

full board. However, a company that routinely engages in public or private offerings to finance its operations may decide that a board committee--such as a finance committee--should be authorized to act on all but the most significant offerings.ⁿ⁵⁵

The number and expertise of directors is another key determinant of committee structure. A company with a small board will ordinarily not find it useful to create numerous board committees, because directors would be called upon to serve on multiple committees, thereby reducing or eliminating the efficiency of operating through committees. A company with a large board of directors, however, may find it useful to divide its work and allocate certain responsibilities to the directors deemed most capable of handling them.

Perhaps most importantly, the Sarbanes-Oxley Act and the corporate governance standards of the market on which a company's securities are traded drive the formation of board committees. In fact, as far back as the 1970s, the NYSE required that every listed company have an audit committee. More recently, Sarbanes-Oxley required public companies listed or traded on a national securities exchange or national securities association to have an audit committee comprised of independent directors, and the NYSE corporate governance standardsⁿ⁵⁶ mandate that every listed company have audit, compensation, and nominating/corporate governance committees, each with specifically delineated responsibilities and each composed entirely of independent directors, subject to certain exceptions.

The board is generally responsible for determining whether and the extent to which it delegates authority to its committees, and for deciding which matters should be handled at the committee level and which should come before the full board. Recently, however, statutory and regulatory requirements have contained specific requirements as to the matters that must be addressed by board committees. For example, Sarbanes-Oxley Section 301 requires that the audit committee be directly responsible for the appointment, compensation and oversight of the independent auditor.ⁿ⁵⁷ Similarly, the NYSE listing standards assign to the compensation committee specific responsibilities with respect to the compensation of the CEO and, to a lesser degree, other senior officers.ⁿ⁵⁸

[b] Types of Committees

As discussed above, the NYSE and NASDAQ listing standards generally require that listed companies have audit, compensation and nominating/corporate governance committees comprised solely of "independent" directors.ⁿ⁵⁹ Sarbanes-Oxley gives the audit committee (to the exclusion of the board) sole responsibility for certain matters, even though the Act refers to the audit committee as a committee of the board.ⁿ⁶⁰ The NYSE and NASDAQ listing standards incorporate these audit committee requirements.ⁿ⁶¹ Both the Sarbanes-Oxley Act and the NYSE assign extensive responsibilities to the audit committee, in addition to its responsibility for the appointment, compensation and oversight of the independent auditor.ⁿ⁶²

The NYSE requires that each listed company have a compensation committeeⁿ⁶³ and a nominating/corporate governance committee.ⁿ⁶⁴ Like the audit committee, these committees also have specifically assigned responsibilities. However, the NYSE listing standards permit a company to allocate the responsibilities of its compensation and nominating/corporate governance committees to "committees of their own denomination, provided the committees are comprised of independent directors."ⁿ⁶⁵ Further, under rules adopted by the SEC in 2003ⁿ⁶⁶ relating to disclosure of the director nominating process, nominating/corporate governance committees have generally implemented specific procedures regarding that process.ⁿ⁶⁷

Corporate boards also frequently form other standing, or permanent, committees, depending upon their companies' industry and other factors. Some examples are as follows:

- *Executive Committee.* Although the functions of an executive committee vary greatly from company to company, in the past, many companies gave the executive committee authority to act between meetings of the board on matters normally requiring board approval, excluding matters reserved to the

board under state corporation law or otherwise.ⁿ⁶⁸ Composition of the executive committee also varied, sometimes including management directors as well as non-management directors, and in some cases consisting entirely of management directors.

In recent years, many companies have moved away from the practice of having executive committees. The plenary authority formerly given to the executive committee has been limited to specified matters or monetary limitations, and some companies that have retained an executive committee have broadened the composition of the committee to include a greater number of non-management directors or even to mirror the composition of the full board in terms of the independence of the directors on the executive committee (*i.e.*, a majority or a substantial majority of the members of the executive committee are independent). These changes in the composition and responsibility of the executive committee have resulted, in part, from institutional investor criticisms that the full board or an independent committee, rather than a management-dominated committee, should address most matters. In addition, advances in conference call and videoconferencing capabilities and the ability to conduct "virtual" meetings have made it easier for companies to convene meetings of the full board, rather than using an executive committee to approve matters in between regular board meetings.

- *Finance Committee.* Again, the structure and duties of a finance committee vary greatly among companies--and many companies do not have such a committee. In general, a finance committee will be charged with overseeing the company's financing requirements, including the sources of funds, private and public borrowings (including approval authority for financing terms), and equity offerings. The composition of this committee is not mandated by law or regulation; consequently, this committee may provide an opportunity for committee service by a director who does not qualify as "independent" for purposes of the audit committee. The use of a finance committee may also relieve some of the burdens placed on audit committees under Sarbanes-Oxley and related implementing SEC regulations. A capital-intensive company might determine to delegate to a finance committee authorization to approve specified levels of capital appropriations; similarly, a company that frequently offers securities to the public might use a finance committee to approve specified terms of the offerings. In both cases, the committee would relieve the board of the burden of having to approve matters that are relatively routine.

- *Public Policy Committee.* Some boards--generally, at companies with a significant presence in their communities or otherwise--form a public policy or similar committee to oversee the company's role in the public sector. Depending on the nature of the company's role, this committee may oversee charitable giving, community relations and activities, lobbying, or other matters.

Other examples of standing committees include those dealing with technology,ⁿ⁶⁹ security, pensions (particularly where a company has a defined benefit plan), and labor relations (in a highly unionized industry). In fact, subject to practical considerations and the risk of "balkanization,"ⁿ⁷⁰ there is no limit to the types of committees that a particular board may decide to form to address the corporation's business and oversight needs.

A board can also form *ad hoc* or special committees, on an as-needed basis. This is often a desirable approach for dealing with a matter that is not likely to recur or to require attention on an ongoing basis. Examples include a committee formed to evaluate claims made in a derivative action; a committee formed to consider whether and to what extent a corporation should indemnify directors and officers against expenses involved in litigation or other claims; a committee formed to oversee an internal investigation; and a committee formed to evaluate or approve the terms of a transaction, particularly one that may involve actual or perceived conflicts of interest, such as a going-private transaction or one in which management may have an interest. The composition of a special committee will largely depend upon the nature of the matter it is overseeing, but such a committee would ordinarily consist of directors who are not only "generally" independent, but also independent with respect to the matter at hand.ⁿ⁷¹

In 2003, in connection with rulemaking under Sarbanes-Oxley concerning attorney conduct, the SEC suggested--but did not mandate--that companies form a Qualified Legal Compliance Committee ("QLCC") that would be responsible for dealing with evidence of "material violations" brought to the company's attention by its attorneys.ⁿ⁷² Among other things, the SEC suggested that the audit committee could serve as a company's QLCC. To date, very few companies have appointed a QLCC, although some commentators have suggested that more companies will form a QLCC if the SEC moves forward with proposed rules requiring attorneys to notify third parties (including the SEC) of material violations.ⁿ⁷³

In May 2009, New York Senator Schumer and Washington Senator Cantwell introduced legislation entitled the "Shareholder *Bill of Rights* Act." This Act would require that boards of public companies form committees to assess and manage risks.

[c] Composition of Committees

The Sarbanes-Oxley Act, SEC implementing rules, and NYSE and NASDAQ listing standards also govern the composition of certain board committees. The audit, compensation and nominating/corporate governance committees must be comprised solely of independent directors. The independence test for audit committee members, set forth in the Sarbanes-Oxley Act, SEC implementing rules and listing standards,ⁿ⁷⁴ is stricter than that for the other two committees. Similarly, the directors on the compensation committee generally must also meet the definition of "outside director" under *Section 162(m) of the Internal Revenue Code* ("IRC") and Internal Revenue Service regulationsⁿ⁷⁵ and the definition of "non-employee director" in Rule 16b-3 under the Securities Exchange Act of 1934 ("1934 Act").ⁿ⁷⁶

SEC rules adopted under the Sarbanes-Oxley Act also call for disclosure as to whether the audit committee includes an "audit committee financial expert."ⁿ⁷⁷ This requirement has caused companies to re-examine the composition of their audit committees to make sure they include a financial expert, rather than disclose that their committees have no such expertise and the reasons for the absence of a financial expert.ⁿ⁷⁸ The NYSE standards also discourage service on a listed company audit committee by anyone already serving on the audit committees of three other public companies.ⁿ⁷⁹

Institutional investors, proxy voting advisory services and corporate governance rating services also influence the composition of board committees. For example, RiskMetrics, which issues both proxy voting recommendations and corporate governance ratings, has its own standards related to director independence.ⁿ⁸⁰ So, too, the California Public Employees Retirement System ("CalPERS"),ⁿ⁸¹ Teachers Insurance and Annuity Association-College Retirement Equities Fund ("TIAA-CREF")ⁿ⁸² and other institutional investors maintain corporate governance principles with their own custom definitions of independence. These definitions tend to be more strict than the NYSE standards. For example, the TIAA-CREF definition provides that a "recent" former employee of a company is not independent,ⁿ⁸³ in contrast to the NYSE three-year standard.ⁿ⁸⁴ Some of these groups have used their own standards of director independence to withhold votes from directors whose boards have found them to be independent under the NYSE listing standards and their own categorical independence standards.ⁿ⁸⁵

In recent years it has become a best practice for committee assignments to be recommended to the board by the nominating and corporate governance committee, since that committee is presumed to be most attuned to the directors' abilities and how those abilities relate to the company's needs. Corporate governance commentators also have discussed the advisability of rotating committee assignments, so that members of a particular committee do not become "stale," and to assure that fresh perspectives are brought to bear on the various committees' responsibilities. In practice, however, rotation may be difficult to implement, primarily because of the specialized knowledge and experience requirements applicable to certain committees (for example, the "financial literacy" and other requirements applicable to audit committee membersⁿ⁸⁶) and because rotation may deprive a committee of historical knowledge and continuity. For this and other reasons, companies may choose to rotate only individual members of a committee, rather than rotating an entire committee at one time.

[d] Formation and Operation of Committees

The board committee is a creature of state corporation laws that permit a board to create and rely upon its committees.ⁿ⁸⁷ These state law provisions are generally incorporated into a corporation's by-laws, which generally set forth the minimum statutory requirements governing the formation of board committees.ⁿ⁸⁸ The by-laws can also specify which types of committees may be formed, and they may contain additional requirements pertaining to committee membership, such as those relating to independence or other skills on the part of committee members. However, mandating a particular type of committee in the by-laws or dictating a committee's composition deprives the board of flexibility. Instead, committee membership requirements and responsibilities are generally left to a committee charter. Finally, by-laws may contain procedural requirements applicable to a committee, such as quorum and attendance requirements; however, by-laws generally deal with these issues by appropriate cross-reference to similar provisions applicable to the full board.

A committee is formed by action of the board, usually in the form of a resolution designating the committee and its members and giving a very brief description of the committee's function. Under the laws of some states (including Delawareⁿ⁸⁹), alternate members of the committee can be designated, as well. Changes in committee composition also require board action.

In conjunction with the formation of a committee, the committee should adopt a committee charter, approved by the full board, specifying the committee's composition and duties in detail. The charter can then be used as a tool to assure that the committee is performing its assigned responsibilities. In conjunction with the charter, it is useful to prepare a detailed annual calendar of the committee's responsibilities to assure that matters are handled in a timely fashion.ⁿ⁹⁰

The formation of a committee, or changes in committee membership, may trigger various notice and disclosure requirements. For example, NYSE-listed companies must notify the NYSE any time a new audit, nominating/corporate governance or compensation committee member is designated, and the notice must confirm the audit committee members' financial literacy.ⁿ⁹¹ Even where notice is not legally required, a company may find it desirable to announce the formation of a committee or the designation of a new member. Companies also frequently list the composition of their board committees on their websites, and these sites should be kept current as committee composition changes.

An NYSE-listed company's nominating/corporate governance, compensation and audit committees must adopt charters,ⁿ⁹² and these charters must be posted on the company's website. Under the SEC's proxy rules, a company must disclose whether a current copy of the applicable committee charter is available on the company's website, and if not, it must be provided to Stockholders once every three years (and in any year materially amended).ⁿ⁹³ The SEC rules regarding disclosure about director nominations also require publication of the nominating/corporate governance committee charter, either in the proxy statement or on a company's website.ⁿ⁹⁴ Increasingly, website posting has become a "best practice" with respect to all committees, although some companies find it useful to append the committee charters to the proxy statement every year, in part so that the proxy statement can provide a complete description of the duties of the board and its committees. Some institutional investors have also suggested that various policies adopted by committees, such as audit committee policies regarding the use of the company's independent auditors to perform audit-related and non-audit services, should be posted on the website.

As noted above,ⁿ⁹⁵ the Sarbanes-Oxley Act gives the audit committee (to the exclusion of the board) sole responsibility for certain matters, generally concerning the relationship with the company's independent auditor.ⁿ⁹⁶ The NYSE listing standards contemplate that the compensation committee may have sole authority to fix the compensation of the CEO.ⁿ⁹⁷

Some have expressed concern that giving a board committee sole authority to deal with a particular matter, or that having too many committees, may cause the board to become "balkanized"--each committee having its own area of responsibility, with limited oversight by the full board, potentially depriving other directors and the board as a whole of

the ability to execute their responsibilities in a meaningful manner.⁹⁸ One way of minimizing or avoiding this problem is to assure that every board committee makes a report on its activities at every regular board meeting. The report is generally given by the committee chair, who summarizes the committee's deliberations and actions since the last board meeting and can answer questions from other directors. The corporate secretary can assist each committee chair by preparing an outline of the committee's deliberations and actions prior to the next board meeting. Another way to keep the full board informed is to provide copies of all committee agendas and minutes to the full board on a regular basis. Some companies also permit or encourage directors who do not serve on a particular committee to attend that committee's meeting. While this practice may be legitimate, it may complicate the logistics of committee meetings. More important, it may also raise concerns regarding a committee's independence, particularly if the non-member in attendance is not an independent director or has a personal interest in any matters under discussion.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion Business & Corporate Law Corporations Directors & Officers Scope of Authority Meetings Procedures Business & Corporate Law Corporations Directors & Officers Terms in Office General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* § 4.04 above; *Del. Code Ann. tit. 8, § 141(a)* (2003); Model Bus. Corp. Act § 8.01(b).

(n2)Footnote 2. *See* § 4.02 above; *Del. Code Ann. tit. 8, § 141(c)* (2003).

(n3)Footnote 3. The Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., 29 U.S.C.).

(n4)Footnote 4. NYSE Listed Company Manual § 303A. The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n5)Footnote 5. The National Association of Securities Dealers (the "NASD") owns and operates the NASD Automated Quotation System (the "NASDAQ").

(n6)Footnote 6. *See, e.g., Del. Code Ann. tit. 8, § 141(b)* (2003) (board shall consist of 1 or more members); P.R. Laws Ann. tit. 14, § 14.01 (Puerto Rico requires at least 3 directors).

(n7)Footnote 7. *See, e.g., Del. Code Ann. tit. 8, § 141(b)* (2003) ("The number of directors shall be fixed by ... the bylaws, unless the certificate of incorporation fixes the number ..."); Model Bus. Corp. Act § 8.03(a) ("A board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws.").

(n8)Footnote 8. *See* 1 Drexler et al., *Delaware Corporation Law and Practice* § 13.01[2] (LexisNexis Matthew Bender).

(n9)Footnote 9. Business Roundtable, Principles of Corporate Governance 19 (November 2005), available at <http://www.businessroundtable.org/taskForces/taskforce/document.aspx?qs=6C65BF159F949514481138A74EB1851159169FEB5693EB5> and reproduced in Appendix A to this treatise.

(n10)Footnote 10. Business Roundtable, Principles of Corporate Governance 19 (November 2005).

(n11)Footnote 11. American Bar Association ("ABA") Committee on Corporate Laws, Corporate Director's Guidebook 28 (5th ed. 2007) [hereinafter ABA Corporate Director's Guidebook].

(n12)Footnote 12. ABA Corporate Director's Guidebook 50.

(n13)Footnote 13. See Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board: Designing Corporate Boards for a Complex World* 89 (Harv. Bus. Sch. Press 2004) [hereinafter Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* (2004)] ("[W]e remain strongly committed to the proposition that boards should strive to be as small as they can be ... If pushed to offer a number, we would suggest a maximum of ten directors.").

(n14)Footnote 14. Spencer Stuart, Spencer Stuart Board Index 2008, at 10.

(n15)Footnote 15. ABA Corporate Director's Guidebook 50.

(n16)Footnote 16. The National Association of Securities Dealers (the "NASD") owns and operates the NASD Automated Quotation system (the "NASDAQ").

(n17)Footnote 17. NYSE Listed Company Manual § 303A.01; Nasdaq Rule 4350(c). Nasdaq Rule 4350 and related interpretations, IM-4350-4, IM-4350-5 and IM-4350-7, are reproduced in Appendix C to this treatise.

(n18)Footnote 18. Business Roundtable, Principles of Corporate Governance 14 (November 2005).

(n19)Footnote 19. Business Roundtable, Corporate Governance Survey (Dec. 2008) (90% of companies surveyed reported that their boards are at least 80% independent), *available at* www.businessroundtable.org.

(n20)Footnote 20. NYSE Listed Company Manual § 303A.02(b); Nasdaq Rule 4200(a)(15). See also discussion in §§ 8.03[1] and [2] below.

(n21)Footnote 21. NYSE Listed Company Manual § 303A.02(a); Nasdaq Rule 4200(a)(15).

(n22)Footnote 22. NYSE Listed Company Manual § 303A.02(a) Commentary. The NYSE has proposed to eliminate these requirements, as well as the "categorical" standards approach, primarily because extensive disclosures regarding director independence are now required under Item 407 of Regulation S-K. Among other things, where a company uses its own independence standards (including in addition to those of the exchange on which its securities are listed), Item 407 requires disclosure of those standards, as well as of the category and type of any transactions considered by the board in determining that a director is independent under those standards.

(n23)Footnote 23. See Regulation S-K Item 407(a)(3), as set forth in Securities and Exchange Commission Release No. 33-8732A/34-54302A.

(n24)Footnote 24. See § 8.03 below.

(n25)Footnote 25. See, e.g., John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board*, 59 *Bus. Law* 421 (Feb. 2004); Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 121 (2004).

(n26)Footnote 26. John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board*, 59 *Bus. Law* 421, 422 (Feb. 2004).

(n27)Footnote 27. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 121 (2004).

(n28)Footnote 28. See Business Roundtable, Principles of Corporate Governance 13 (November 2005) ("Because the corporation's need for particular backgrounds and experience may change over time, the board should monitor the mix of skills and experience that directors bring to the board ... to assess, at each stage in the life of the corporation,

whether the board has the necessary tools to perform its oversight function effectively."). *See also* Business Roundtable, *The Nominating Process and Corporate Governance Committees: Principles and Commentary 9* (2004), reproduced in Appendix 8-B to Chapter 8 *below* ("The composition of the board should reflect a mix of talents, experience, expertise and perspective appropriate to the corporation's circumstances and strategic challenges, and the corporate governance committee should plan ahead for changes in board composition.").

(n29)Footnote 29. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 119 (2004). Carter & Lorsch suggest the following types of directors, in addition to the CEO: (1) two or three directors whose strength is keeping the other board members out of trouble; (2) a least one or two directors who really understand the numbers, the financial reporting and all the complex accounting issues; (3) three or four directors with good track records as CEOs; (4) one or two directors with high-level executive experience leading major divisions in large companies; (5) a director with experience in developing corporate strategy; (6) a business leader who can also constructively understand the company's business in light of wider community attitude--someone who understands business but is familiar with life in the broader community. For a discussion of a SEC official's view of what it takes to be an effective director today, see Brian G. Cartwright, Remarks Before the 2006 Investment Company Directors' Conference (November 15, 2006) available at www.sec.gov/news/speech/2006/spch111506bgc.htm.

(n30)Footnote 30. Business Roundtable, *The Nominating Process and Corporate Governance Committees: Principles and Commentary 9* (2004).

(n31)Footnote 31. *See* Drury, "Boardroom Brain Drain," *Forbes.com* (October 16, 2006).

(n32)Footnote 32. The Higgs Report in the United Kingdom recommended that non-executive directors should normally serve two three-year terms and longer only in exceptional circumstances. Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003), P 11.19.

(n33)Footnote 33. *See* Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 129 (2004).

(n34)Footnote 34. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 130 (2004).

(n35)Footnote 35. *See, e.g.*, Murdoch Provokes Protest by Putting Son James on Board, *The Independent* (Feb. 15, 2003).

(n36)Footnote 36. *See also* discussion of restrictions on director tenure at § 8.03[2][c] *below* .

(n37)Footnote 37. For a discussion of limitations on service on other boards of directors, *see* § 8.03[2][d] *below*.

(n38)Footnote 38. *See* § 7.08 *below*.

(n39)Footnote 39. ABA Corporate Director's Guidebook 43.

(n40)Footnote 40. *See* Carpenter, "Directors Told to Ask Probing Questions, Set Up Ground Rules for Executive Sessions," *BNA Corporate Accountability Report*, Vol. 3, No. 43 (November 4, 2005).

(n41)Footnote 41. ABA Corporate Director's Guidebook 43.

(n42)Footnote 42. *See* Business Roundtable, *Principles of Corporate Governance* 15 (November 2005).

(n43)Footnote 43. *See* Business Roundtable, *Principles of Corporate Governance* 15 (November 2005).

(n44)Footnote 44. *See* Chuck Lucier et al., *CEO Succession 2003: The Perils of "Good" Governance, Strategy + Business* (Booz Allen Hamilton, Spring 2004).

(n45)Footnote 45. See The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 19 (2003) *available at* www.conference-board.org/pdf_free/758.pdf.

(n46)Footnote 46. Business Roundtable, Corporate Governance Survey (Oct. 2007) (90% of companies surveyed reported having an independent chairman, lead director or presiding director), *available at* www.businessroundtable.org.

(n47)Footnote 47. NYSE Rule 303A.03 and Commentary. According to this commentary, there need not be a single presiding director at all executive sessions, and a company may disclose the procedure by which a presiding director is selected for each executive session. However, the use of a single presiding director at executive sessions of the board is increasingly being viewed as a best practice.

(n48)Footnote 48. Two commentators suggest that "creating a lead director with ... an extensive list of duties may undercut the chairman's role and impair the free flow of communication between the chairman/CEO and the other directors. If the lead director assumes too much power, he may complicate and even limit the ability of the other directors to work with the chairman/CEO and to govern." Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 102-103 (2004).

(n49)Footnote 49. See RiskMetrics Governance Analytics, 2009 U.S. Proxy Voting Manual, Board of Directors - Independent Chairman (Separate Chairman/CEO), *available at* <https://riskmetrics.com/newmain.php#>.

(n50)Footnote 50. See "For BofA's Lewis, Merrill Was One Deal Too Many" at <http://dealbook.blogs.nytimes.com/2009/04/30/for-bofas-lewis-merrill-was-one-deal-too-many/?scp=4&sq=bank%20of%20america%20>

(n51)Footnote 51. <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.

(n52)Footnote 52. *Del. Code Ann. tit. 8, § 141(c)(2)*. See also 1 Drexler et al., *Delaware Corporation Law and Practice § 13.01[8]* (LexisNexis Matthew Bender).

(n53)Footnote 53. *Del. Code Ann. tit. 8, § 141(e)*.

(n54)Footnote 54. See the discussions of specific board committees in Chapter 8 (Nominating and Corporate Governance Committee), Chapter 9 (Audit Committee) and Chapter 10 (Compensation Committee) *below*.

(n55)Footnote 55. Some state corporation statutes may require action by the full board on certain types of offerings, such as offerings of equity securities. In addition, the extent to which full board action may be required is also influenced by the views of underwriters and their counsel.

(n56)Footnote 56. NYSE Listed Company Manual §§ 303A.04-303A.06. Similarly, NASDAQ and other securities markets mandate audit committees and require that certain functions be performed by compensation and nominating committees or a majority of independent directors. See Nasdaq Rule 4350(c)(3) and (4).

(n57)Footnote 57. Sarbanes-Oxley § 301, *15 U.S.C. § 78j-1(m)*.

(n58)Footnote 58. NYSE Listed Company Manual § 303A.05(b)(i).

(n59)Footnote 59. Under the NASDAQ listing standards, a company may have a majority of its independent directors perform the required functions of the compensation and nominating/corporate governance committees. Nasdaq Rule 4350(c)(3) and (4).

(n60)Footnote 60. See Sarbanes-Oxley Act § 301, *15 U.S.C. § 78j-1(m)*.

(n61)Footnote 61. See NYSE Listed Company Manual § 303A.06; Nasdaq Rule 4350(d).

- (n62)Footnote 62. *See* Chapter 9 for a detailed discussion of the responsibilities of audit committees.
- (n63)Footnote 63. NYSE Listed Company Manual § 303A.05.
- (n64)Footnote 64. NYSE Listed Company Manual § 303A.04.
- (n65)Footnote 65. *See* commentary to NYSE Listed Company Manual §§ 303A.04 and 303A.05.
- (n66)Footnote 66. *See* SEC Release Nos. 33-8340, 34-48825 (Nov. 24, 2003).
- (n67)Footnote 67. *See* Chapters 8 and 10 for discussions of the nominating/corporate governance committee and compensation committee, respectively.
- (n68)Footnote 68. Sarbanes-Oxley Act § 301, *15 U.S.C. § 78j-1(m)*.
- (n69)Footnote 69. *See* Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 89 (2004) (A global resource company, BHP Billiton, has added several nondirectors with advanced scientific and technical skills to its environment committee.).
- (n70)Footnote 70. *See* discussion in § 7.01[4][d] below.
- (n71)Footnote 71. *See* Chapter 11 below for discussion of special committees.
- (n72)Footnote 72. *See* SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003). *See also* § 14.07[3] below discussing SEC attorney conduct rules and § 14.07[3][f] below discussing QLCCs.
- (n73)Footnote 73. *See* S. Hackett, *QLCCs. The In-House Perspective*, Wall St. Lawyer 10 (May 2004).
- (n74)Footnote 74. Sarbanes-Oxley Act § 301; 1934 Act Rule 10A-3; NYSE Listed Company Manual §§ 303A.06 and 303A.07; and NASDAQ Rule 4350(d).
- (n75)Footnote 75. *Treas. Reg. § 1.162-27(c)(4)*. *See* § 10.05[1][a] below for discussion of *IRC* § 162(m) independence requirements.
- (n76)Footnote 76. *See* § 10.05[1][b] below for discussion of 1934 Act Rule 16b-3 independence requirements.
- (n77)Footnote 77. *See* SEC Release No. 33-8177 (Jan. 23, 2003).
- (n78)Footnote 78. *See* Regulation S-K Item 401(h)(1)(iii), *17 CFR § 229.401(h)(1)(iii) (2005)*.
- (n79)Footnote 79. *See* NYSE Listed Company Manual § 303A.07(a) Commentary.
- (n80)Footnote 80. *See* www.riskmetrics.com. *See also* § 8.03[1][a][ii] below.
- (n81)Footnote 81. *See* www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf.
- (n82)Footnote 82. *See* TIAA-CREF Policy Statement on Corporate Governance, *available at* www.tiaa-cref.org/pubs/pdf/governance_policy/pdf.
- (n83)Footnote 83. *See* TIAA-CREF Policy Statement on Corporate Governance at V.A.1. ("The definition of independence should not be limited to stock exchange listing standards. At a minimum, we believe that to be independent a director and his or her immediate family members should have no present or recent employment with the company, nor any substantial connection of a personal or financial nature other than ownership of equity in the company. Independence requirements should be interpreted broadly to ensure there is no conflict of interest, in fact or in

appearance, that might compromise a director's objectivity and loyalty to shareholders. An independent director should not provide services to the company or be affiliated with an organization that provides goods or services to the company if a disinterested observer would consider the relationship 'substantial.' Director independence may sometimes be influenced by factors not subject to disclosure. Personal or business relationships, even without a financial component, can compromise independence. Boards should periodically evaluate the independence of each director based on all relevant information and should disclose their findings to shareholders.").

(n84)Footnote 84. See NYSE Listed Company Manual § 303A.02(b)(i).

(n85)Footnote 85. See, e.g., Press Release, *CalPERS Votes Proxy Against Disney's Eisner--Audit Committee Vote Also Withheld* (Feb. 25, 2004), available at www.calpers.ca.gov/index.jsp?by=/about/press/pr-2004/feb/votesproxy.xml.

(n86)Footnote 86. See Chapter 9, The Audit Committee, *below*.

(n87)Footnote 87. See, e.g., *Del. Code Ann. tit. 8, § 141(c)* (2003).

(n88)Footnote 88. See, e.g., *Del. Code Ann. tit. 8, § 141(c)* (2003). See also 1 Drexler et al., *Delaware Corporation Law and Practice § 13.01[8]* (LexisNexis Matthew Bender) for discussion of § 141(c) board committee provisions.

(n89)Footnote 89. See *Del. Code Ann. tit. 8, § 141(c)(2)* (2003).

(n90)Footnote 90. See Appendix 9-B to Chapter 9 *below* for a sample of such a calendar.

(n91)Footnote 91. See NYSE "Section 303A Interim Written Affirmation" available at www.nyse.com.

(n92)Footnote 92. See NYSE Listed Company Manual §§ 303A.04, 303A.05 and 303A.07. A sample committee charter for each of a nominating/corporate governance, compensation and audit committee is reproduced in Appendix 8-A, Appendix 10-A and Appendix 9-A *below*, respectively.

(n93)Footnote 93. Regulation S-K, Item 407, Instruction 2.

(n94)Footnote 94. See SEC Release Nos. 33-8340, 34-48825 (Nov. 24, 2003).

(n95)Footnote 95. See § 7.01[4][a] *above*.

(n96)Footnote 96. See Sarbanes-Oxley § 301; *15 U.S.C. § 78j-1(m)*.

(n97)Footnote 97. NYSE Listed Company Manual § 303A.05. The notion that the compensation committee should have sole authority with respect to the CEO's compensation has generated comment and controversy, as some institutional owners, among others, believe that this authority should reside with all independent directors rather than just the members of one committee.

(n98)Footnote 98. See, e.g., John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board*, 59 *Bus. Law* 421, 423 (Feb. 2004).



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.02

AUTHOR: Robert B. Lamm

§ 7.02 Board Delegation of Authority

State corporation law generally provides that the business and affairs of every corporation is managed "by or under the direction of" the corporation's board of directors.ⁿ¹ Thus, a board may delegate its authority to manage the corporation's business and affairs to officers and employees, except where board action is specifically required by statute or a corporation's charter documents. In this regard, state corporation laws generally provide that some or all of the following require board action: changes in charter documents, authorization of dividends, nomination of directors, election of officers, approval of mergers, sales of substantially all the corporation's assets, and corporate liquidation. Some of these events also require shareholder action.ⁿ² In addition, the board has general oversight responsibilities.ⁿ³ Nevertheless, a board has considerable discretion with respect to the level of its involvement in business decisions, and an informed decision by the board to delegate responsibility for a matter or to remain directly involved is protected by the business judgment rule.ⁿ⁴

In practice, "some directors strongly believe that it's management's job to run the business and the board's job to decide whether the outcomes are satisfactory. ... Other directors will prefer to be more involved. They will delegate less to management and want to share responsibility for leading the company and approving key decisions."ⁿ⁵ There is no right or wrong answer in this regard, but the directors and CEO should have a common understanding regarding their respective roles and responsibilities.ⁿ⁶ Similarly, companies' approaches to the formality of delegating specific authority to management varies widely. Some companies have detailed authorization schedules while others operate pursuant to broad resolutions.

In the wake of corporate scandals in 2000-2002, the Sarbanes-Oxley Act and the subsequent focus on internal controls under Section 404 of the Sarbanes-Oxley Act,ⁿ⁷ there is a trend toward greater formality in delegations of authority. What is most important is that "[t]he board and senior management ... have a clear understanding of what level or types of decisions require specific board approval."ⁿ⁸ Boards use a wide variety of approaches to achieve this "clear understanding." Some boards adopt very simple, straightforward delegations specifying that any matter involving more than a certain amount requires board (or possibly committee) approval, and that matters involving lesser amounts can be authorized by management as it sees fit. Others use lengthy, detailed delegations that separately address different aspects of the company's operations and/or specify varying levels of authority for different individuals and/or departments, provide detailed specifications regarding sub-delegation authority, and address numerous other matters.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral
OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretion

FOOTNOTES:

(n1)Footnote 1. *See e.g. Del. Code Ann. tit. 8, §§ 141(a), 141(c)(1), (2)* (2003).

(n2)Footnote 2. *See e.g. Del. Code Ann. tit. 8, § 141(c)* (2003).

(n3)Footnote 3. ABA Corporate Director's Guidebook 5.

(n4)Footnote 4. *See* Chapter 4 *above* for discussion of the business judgment rule.

(n5)Footnote 5. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 74-75 (2004).

(n6)Footnote 6. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 75 (2004).

(n7)Footnote 7. *See* § 14.02[2] *below* for further discussion of internal controls.

(n8)Footnote 8. Business Roundtable, Principles of Corporate Governance 9 (November 2005).



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.03

AUTHOR: Robert B. Lamm

§ 7.03 Evaluation of the CEO and Senior Management

One of the board processes and responsibilities that is most critical to the proper functioning of the board and, indeed, of the corporation, is evaluation of the CEO and senior management.

[1] Who Conducts the Evaluation?

Responsibility for evaluating the CEO should be limited to the independent members of the board, due to the conflicts of interest and other difficulties that would be present if management members of the board were to evaluate their superior. Companies may handle the evaluation of management in a variety of ways, but the process should generally involve an independent board committee, typically the compensation committee, which will have been involved in setting specific performance goals for the CEO. The NYSE listing standards require the compensation committee to review and approve corporate goals and objectives relative to CEO compensation and to evaluate the CEO's performance in light of those goals.¹ Members of the nominating/corporate governance committee may also be involved or have this responsibility, and other independent directors are also likely to participate in some manner, formally or informally. In evaluating the CEO, it is advisable for the directors to have some knowledge of or at least access to members of management who report to the CEO, so that the directors conducting the evaluation can assess the CEO's leadership attributes and skills, among other things. In addition, the directors should consider having the CEO present an assessment of his or her performance as against previously established goals.

There are a number of processes by which the board can evaluate members of senior management other than the CEO. Some companies may choose to have this evaluation conducted by the independent directors, or a committee of independent directors, in consultation with the CEO. Other companies may have the CEO present his or her views on direct reports to the board as a first step, with the independent directors making a separate assessment; it may be desirable for this assessment to be made by the compensation committee, given its responsibilities for executive compensation generally, including establishment of the performance goals on which much of that compensation may be based. In still other cases, the CEO may report on other members of senior management without independent review. However, since this evaluation process can be a key component of the board's consideration of management succession (because it affords the directors an opportunity to assess the abilities and limitations of the individuals who report to the CEO), it may be desirable for the board to take a more active role in this process rather than merely accepting the CEO's

opinions. In any event, companies engage in a wide variety of evaluation processes and may experiment with new processes from time to time to determine which ones work best for them.

[2] The Evaluation Process

The CEO should possess a number of critical attributes, among them competence, integrity, leadership, and strategic skills. However, the qualities most desirable in a particular company's CEO will, of necessity, depend upon factors specific to the company, such as its industry, its recent history, and its competitive environment. Thus, the first task of the evaluators should be to determine which qualities are the most desirable in that particular company's CEO, at that time. This task needs to be completed at the beginning of each evaluation cycle, to give the CEO an understanding of the basis on which his or her performance will be judged. Some companies have a job description for the CEO; if so, that should be consulted in launching the evaluation process. Of course, the job description should be up-to-date; therefore, a first step would be to review the description and determine whether it needs to be updated or modified in any way.

Once the critical CEO qualities are determined, the next step should be to review the goals set by the compensation committee in consultation with the CEO,² as well as any other objectives and benchmarks that the CEO is charged with achieving during the evaluation cycle.³ Although every evaluation process will entail some degree of subjectivity, fixing specific goals should help to focus the evaluation and make it more objective. Again, this step needs to be addressed at the beginning of each evaluation cycle.

Assuming that the CEO's critical attributes and benchmarks are clear (and are communicated clearly to the CEO), the actual evaluation process can take many different forms. Some companies use a written checklist that is completed by each independent director and returned to the chair of the committee overseeing the evaluation; depending upon the company's culture and other factors, it may be desirable to have these forms submitted anonymously. In other cases, members of the evaluating committee use a written checklist as the basis for personal interviews with each non-management director to obtain his or her views concerning the CEO's attributes and achievement of the specified objectives. The latter procedure may be desirable to the extent that it does not create a record of potential CEO shortcomings that can later be used in litigation. A similar procedure would be appropriate to learn the views of the CEO's subordinates, who may be uncomfortable creating a written record of any criticisms they may have of the CEO. As previously noted, the process should also include having the CEO present an assessment of his or her performance as against previously established goals.

As indicated, the last critical step in the evaluation is discussing the results with the CEO--giving him or her an opportunity to review the evaluation, ask questions, and, where appropriate, rebut criticisms. In other words, the evaluation should be part of a communication process between the CEO and the independent directors, rather than a one-way, once-a-year, critique. There are various methods by which the independent directors can communicate the results of the evaluation to the CEO. Some companies may choose to have the report made by the chair of the committee conducting the evaluation, or by a non-executive chairman or lead or presiding director. Others may determine that the report should be made by a group of directors; this approach may be desirable where the evaluation generates strong criticism, so that the criticism does not seem to be coming from only one individual. Still other companies may have the report given to the CEO in the presence of all independent directors. Although evaluation reports may be given in writing, most companies choose to deliver the reports orally, primarily to avoid creating records that may be discoverable in litigation.

Similar considerations and procedures apply with respect to the evaluation of other members of senior management, subject to the understanding, discussed above, that the CEO will have a greater role in the evaluation of senior management and may be the one who reports the results of the evaluation to the managers being evaluated. Depending upon the circumstances, it also may be desirable for a limited number of non-employee directors to participate in this process, particularly to the extent that management succession issues are being discussed.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral
OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewSecurities
LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* NYSE Listed Company Manual § 303A.05(b)(i)(A).

(n2)Footnote 2. *See* § 7.03[1] above.

(n3)Footnote 3. *See* § 15.03[2][b] below for discussion of the various performance measures, goals and related issues that the compensation committee may consider.



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.04

AUTHOR: Robert B. Lamm

§ 7.04 Board, Committee and Director Evaluations

When it adopted new listing standards in late 2003, the NYSE mandated what some companies had considered a "best practice" for several years--namely, that the board and its principal committees (nominating/corporate governance, compensation and audit) conduct an annual self-evaluation or self-assessment.ⁿ¹

The NYSE standards discuss the broad goal of the self-assessments: to determine whether the board and its committees "are functioning effectively."ⁿ² The standards, however, do not specify any criteria by which the achievement of this goal is to be measured, nor do they specify the manner in which the self-assessments are to be conducted. Thus, as is the case with respect to evaluations of the CEO and senior management, boards of listed companies are free to select the criteria and procedures that are most appropriate for them.

Many companies rely upon the nominating/corporate governance committee to supervise the assessment of the board as a whole, but the process can be conducted by the full board, by another committee, or by an outside facilitator acting on its own or in conjunction with any of the foregoing. A third-party facilitator, on a periodic basis, can often be helpful in conducting the assessment process, by helping the directors overcome hesitation in criticizing their colleagues, encouraging them to be candid and forthright, and serving as a neutral intermediary.

Self-evaluation procedures range from the use of a questionnaire asking each director to assess the abilities and achievements of the board, to a process conducted orally in its entirety. One of the benefits of following an oral process is that it avoids the creation of a written record that can be used as a "road map" for plaintiffs in any subsequent litigation relating to the board (although some federal and state courts have recognized a privilege of self-critical analysisⁿ³). If a questionnaire or other document is used in the self-evaluation process, it may be advisable, following completion of the process, to destroy all copies containing notes or other information that could be used against the company or the board in subsequent litigation. Regardless of whether the process is conducted orally or in writing, the board needs to decide whether it should be handled on an anonymous basis; if so, the use of a third-party facilitator may be essential to the process. Committee self-assessments generally follow the same pattern, including the use of third-party facilitators.

Companies may want to consider "mixing up" the manner in which board and/or committee evaluations are performed

from time to time. For example, where a company generally uses a questionnaire process on an annual basis, it may be desirable to supplement or substitute this with personal interviews every so often (such as every other year or every three years) and to consider using a facilitator at some point (possibly every five years), in all cases to assure that the evaluation process retains some freshness and vitality. In any case, whatever processes or schedules may be followed, the nature of the questions and topics covered should be reviewed and revised every year to assure that the process addresses regulatory and governance developments.

Board and committee self-evaluations also can be used to effect improvements in a company's governance processes and practices. For example, they may bring to light the need for improvements in the flow of information to the board, the need for amendments to a committee charter, or the need to have additional members of management present at board or committee meetings.

The NYSE listing standards do not require that individual directors be evaluated. However, most boards conduct an individual assessment process--albeit an informal one--as part of the annual process of designating nominees for election as director, when each nominee's strengths and weaknesses are considered in determining whether he or she should stand for election.ⁿ⁴ Some boards also conduct individual assessments on a more formal basis.ⁿ⁵ In addition, some boards conduct evaluations of the non-executive chairman or the lead or presiding director.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* NYSE Listed Company Manual §§ 303A.04[b][ii], 303A.05[b][ii], and 303A.07[c][ii], respectively.

(n2)Footnote 2. *See* NYSE Listed Company Manual § 303A.09 Commentary.

(n3)Footnote 3. *See* L. Herzeca and C. Herzeca, *The Case for Privileged Board Self-Evaluation Programs*, *The Corporate Governance Advisor* 1 (Sept./Oct. 2003).

(n4)Footnote 4. *See* § 8.03[1][c] below for a discussion of evaluating incumbent directors before deciding whether to renominate them.

(n5)Footnote 5. Some commentators suggest that "Performance appraisal for individual directors, as well as boards, is an idea whose time has come." Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 125 (2004). *See also* The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 21 (2003) available at www.conference-board.org/pdf_free/758.pdf ("The [Conference Board] Commission believes that each board should develop a three-tier director evaluation mechanism which includes evaluation of the performance of the board as a whole, the performance of each committee and the performance of each individual director, as necessary.").



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.05

AUTHOR: Robert B. Lamm

§ 7.05 Succession Planning

Succession planning is another critical responsibility of the board. In fact, the NYSE listing standards require that a company's corporate governance guidelines or principles address management succession,ⁿ¹ and the Business Roundtable states that long-term planning for CEO and senior management development and succession is one of the board's most important functions.ⁿ²

Succession planning encompasses two areas--succession over the near term (including succession emergencies, such as the CEO's severe illness or sudden departure for other reasons), as well as long-term succession plans. Both types of succession planning are critical. Long-term succession planning facilitates the grooming of internal candidates for promotion. Moreover, the succession planning process can be used to weed out managers who are not performing adequately; again, this flows quite naturally out of the evaluation process. Another important component of succession planning is management development--ensuring that internal talent is being nurtured.

The process by which the CEO and other senior managers are evaluated should serve as a precursor of and natural complement to the succession planning process.ⁿ³ First, the evaluation process should help the non-management directors determine the skill sets to be sought in any succession process. Second, it should afford the directors the opportunity to get to know managers below the CEO level, including their strengths and weaknesses.ⁿ⁴ Third, because evaluations should be performed regularly, they provide an opportunity for the board to update both its views as to necessary skill sets and its knowledge of possible successors. In fact, succession planning should ideally be addressed by the directors promptly following each CEO/senior management evaluation.

In any case, the succession planning process should include identifying and periodically updating the qualities and characteristics of an effective CEO, as well as other senior management positions. These qualities and characteristics should be bases for benchmarks and criteria used in conducting the regular evaluations discussed above, and the results of those evaluations should be reviewed with the CEO and other senior managers. This process, however, should not be limited to periodic reviews; directors should use all of the myriad other activities that take place throughout the year to observe potential successors.ⁿ⁵

Of course, evaluation, succession planning and management development are important not only for the CEO and

senior managers, but also for employees at all levels of the company, to assure that critical functions are being handled by the proper people currently and can continue to be handled properly despite ongoing changes in the workforce. Accordingly, the board should receive a presentation at least annually on company-wide management development and succession plans.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersTerms in OfficeGeneral OverviewSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. NYSE Listed Company Manual § 303A.09 Commentary.

(n2)Footnote 2. Business Roundtable, *The Nominating Process and Corporate Governance Committees: Principles and Commentary 12* (2004), reproduced in Appendix 8-B to Chapter 8 *below* .

(n3)Footnote 3. *See* Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 160-162 (2004).

(n4)Footnote 4. Senior managers should attend board meetings from time to time, so that the board becomes familiar with the senior management team. However, even in a company where that practice is observed, the evaluation process should enable the directors to get to know management outside the formal confines of a board meeting, where senior managers are often constrained by time and other factors from revealing more about themselves.

(n5)Footnote 5. *See* L. Edward Shaw, *Board Responsibility for CEO Succession Planning*, *Insights*, Volume 19, Number 5 (May 2005).



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.06

AUTHOR: Robert B. Lamm

§ 7.06 Strategic Planning and Enterprise Risk Management

The strategic planning process is another key responsibility of the board.ⁿ¹ Many of the factors and procedures discussed above are equally relevant to the directors' role in this process.

As is the case with respect to evaluations and succession planning, the board must work with management on the development of specific strategies and on measuring progress in achieving the goals of those strategies. Also, as with CEO evaluations and succession planning, strategies must be developed with the specifics of the company in mind, including internal factors such as personnel, business processes, culture and ethics, and history, and external factors such as the company's industry, the business and regulatory environment in which it operates, the competitive environment, and its customers and suppliers.

In addition to these factors, strategic planning should include processes to assess and manage risk. The board needs to have management outline areas of vulnerability and concern, as well as plans to address them, including worst-case scenarios and how management would deal with them. In this regard, the NYSE listing standards mandate that the audit committee discuss policies with respect to risk assessment and risk management.ⁿ²

Once the company's specific circumstances and risks are understood, the strategic planning process should consider a broad range of topics, including the best means of growing the business; whether growth should be achieved internally, by acquisition, or by a combination of the two--and, if the latter, in what relative proportions; and whether the company should consider expanding its core businesses and, if so, in what directions. The planning process should also take into account competitive conditions in the industry and actions that might be taken to improve the company's competitiveness, including expanded research and development initiatives. In a highly unionized company, a strategic plan for labor relations would be desirable, including actions that might avoid strikes or other labor disruptions. In a capital-intensive company, plans for capital expansion should be considered. In other words, the specifics of the company outlined above should dictate the planning process.

In considering both risk assessment and strategies, the board must be careful to perform an oversight function, rather than a management function. Particularly in an environment of increased accountability, the board may be inclined to substitute its judgment for that of management. This is not the proper function of the board, however; rather, it should

satisfy itself that management has developed appropriate strategies and is taking appropriate risks (rather than avoiding risk altogether). The board should ask the right questions--including tough ones--and not be satisfied until it gets answers that it can understand. However, the board should not ordinarily substitute its judgment for that of management.ⁿ³

Like CEO and senior manager evaluation and succession planning, strategic planning cannot be done at one meeting; it must be done over time, with objectives being set early in the process. An annual board "retreat" is often a good forum to initiate a detailed discussion of strategic planning. While discussions of these topics require some degree of structure, a retreat can afford a less formal environment, particularly if the retreat takes place away from the company's headquarters and if the board is not faced with other matters that require consideration or approval. The timing of strategy discussions is subject to discretion, but such discussions should ideally take place towards the end of a company's fiscal year, when management and the board have a perspective on the year gone by but are also thinking about the upcoming year. The board should keep in mind, however, that while annual strategy retreats can facilitate deeper discussions, strategic planning is not a "one-shot" affair.ⁿ⁴ Ideally, "the strategy retreat opens up discussion about a number of issues that are progressively dealt with at subsequent board meetings over the ensuing year."ⁿ⁵ A quarterly review of strategic issues may be appropriate, and the strategic objectives should be borne in mind during the year as the board considers adding new directors, management succession, acquisitions and divestitures, and numerous other matters. Further, the board needs to monitor the extent to which management has performed against the strategic plan throughout the year.

Further, the foregoing does not mean that the strategic planning process should only relate to the coming year; longer-range planning is advisable. While there is no template suitable for all companies, many companies develop plans covering one- and three-to-five-year cycles.

Recently, enterprise risk management, or "ERM," has become an important "companion" to the strategic planning process. In general terms, ERM is an integrated process to identify, assess and manage risks of all types across the enterprise. According to the Committee of Sponsoring Organizations of the Treadway Commission (or "COSO"), ERM is designed to: (1) be conducted and applied across the enterprise; (2) be incorporated into the strategic and business planning processes; (3) provide reasonable assurance to management, the board and stakeholders that there is appropriate rigor around risk-related decisions; and (4) optimize the deployment of capital and other resources.ⁿ⁶

Given the above goals of ERM, it can be argued that a strategic planning process cannot be properly conducted unless an ERM process is being conducted on a contemporaneous basis; among other things, how can the strategic plan address the risks facing the company if those risks have not been identified and assessed through an ERM process? For this and other reasons, ERM--including its relevance to the strategic planning process--is generating increased attention within the corporate community and those that follow it. Certain rating agencies have published detailed commentaries on the ERM process and the extent to which the process (or the lack thereof) may have an impact on the financial strength ratings assigned to companies in the insurance and other financial services industries, and ERM may become a factor in debt ratings assigned to companies in other industries. Also, the number of ERM programs being offered by providers of continuing education in the legal, accounting and other fields seems to be growing.

That said, ERM is still a young process, and best practices in ERM are still developing. Consequently, companies are approaching their own ERM processes in different ways. Among the issues to consider is the extent to which one or more committees, and/or the whole board, should oversee the process, and how frequently management should report to the committees and/or the board on the process.ⁿ⁷

In the wake of the financial crisis that began in 2007-2008, many groups, ranging from the media to institutional investors to legislators and regulators, raised concerns that the companies most severely affected by the crisis--*i.e.*, financial services companies--did not have adequate (or in some cases any) risk assessment and management processes. These parties also questioned the extent to which executive compensation policies at these and other companies may

have encouraged excessive or otherwise inappropriate risk-taking. Consequently, the assessment and management of risk, whether through ERM or other practices, is likely to be of increasing interest in the near term. For example, concerns about risk-taking led to the inclusion in the proposed "Shareholder *Bill of Rights* Act," introduced in the U.S. Senate in May 2009, of a proposed requirement that boards of public companies form board committees to assess and manage risks. In addition, the SEC is considering whether greater disclosure is needed concerning how companies and their boards manage risk, both generally and in the context of setting compensation.ⁿ⁸

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Business Roundtable, Principles of Corporate Governance 14 (November 2005) ("The board has responsibility for overseeing and understanding the corporation's strategic plans from their inception through their development and execution by management.").

(n2)Footnote 2. NYSE Listed Company Manual § 303A.07(c)(iii)(D). Enterprise risk management, or "ERM," is discussed below. *See also* § 9.04[2][h][iii] below, discussing the audit committee's role in risk management.

(n3)Footnote 3. Two commentators suggest that the board define the scope of its strategic involvement and clarify whether its expectations are congruent with the executives who are leading the corporation, especially the CEO. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 158-159 (2004).

(n4)Footnote 4. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 159 (2004).

(n5)Footnote 5. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 159-160(2004). *See also* Business Roundtable, Principles of Corporate Governance 4 (May 2002) ("Once the board reviews a strategic plan, the board should regularly monitor implementation of the plan to determine whether it is being implemented effectively and whether changes are needed.").

(n6)Footnote 6. COSO, Enterprise Risk Management-Integrated Framework, September 2004.

(n7)Footnote 7. In this connection, NYSE Rule 303A.07 and related commentary require the audit committee to exercise oversight of "policies with respect to risk assessment and risk management." This language has led some companies to believe that the ERM process must be overseen by the audit committee, rather than by the board and/or other committees, working in tandem. However, another interpretation is that the audit committee should oversee such policies as they relate to accounting and financial reporting (including internal control), rather than the risk assessment process generally. To date, the NYSE has not expressed its views on the proper interpretation of this rule as it relates to ERM.

(n8)Footnote 8. <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.07

AUTHOR: Robert B. Lamm

§ 7.07 Information Flow to the Board

The duties of the board and its committees are increasingly broad. Many of these duties will be spelled out in the company's by-laws, the charters of the various board committees, and in the company's corporate governance principles. Increasingly, these and other documents require far more than the minimum actions necessary to comply with law. In any case, particularly in the current environment of enhanced responsibility, a director must do far more than carry out any such minimum obligations. Rather, the director must be knowledgeable and willing to probe until questions are answered satisfactorily.ⁿ¹ Moreover, even though directors are ordinarily entitled, as a matter of law, to rely upon information and assistance provided by management and third parties, a director cannot rely upon others blindly; instead, a director must constantly evaluate the actions and recommendations of others to assure that such reliance is reasonable and appropriate. In other words, the director must do his or her homework, including doing what is necessary to know and understand the company's business and the legal environment in which it operates. Companies should empower their directors to achieve these goals.

Perhaps the most critical path to director empowerment is information. Information must be provided to the board for various purposes and at various times. Directors should be encouraged "to think about the information they need and how it can best be organized in relation to what they want to know."ⁿ² In all cases, information should be provided in a timely manner and in a form that lends itself to director comprehension. The corporate governance committee, in conjunction with the non-executive chairman or the presiding or lead director if there is one, should assume responsibility for information flow to the directors, in consultation with other directors and senior management of the company, as well as the corporate secretary.

One goal of information flow is to provide the board and committee with the proper level of information prior to each meeting or other action. While directors should receive comprehensive information before taking action, too much information can be as inadvisable as too little; a director may not have time to read volumes of information and, if he or she does read it, critical items may be missed when there is too much information to digest. Thus, management needs to carefully prepare and review the information being provided in advance of board and committee meetings. The information should also be comprehensible and balanced, so that directors can understand the issues and reach decisions accordingly, without having to be concerned that they have misunderstood something too technical or have been forced, even inadvertently, to accept management's recommendations without considering all aspects of an issue. Management

can assist the board in achieving this understanding by providing information concerning the alternatives management considered in recommending a particular course of action and its reasons for the recommendation.

Timing of delivery of information is also important. Delivering materials--particularly, voluminous information--at or shortly prior to a meeting may have obvious adverse consequences. However, it can be equally inadvisable to provide directors with information too far in advance of a meeting; directors may forget what they have reviewed, intervening facts may be overlooked, or both. Although there is no "magic" number, delivery of materials five to seven days prior to the meeting should generally suffice. Where information needs to be delivered substantially in advance, it may be desirable to provide a recap or update at a later date. On the other hand, there may be situations--unusual ones--where information cannot be delivered in advance. On these occasions, management should make a special effort to review critical information in detail, and both management and the directors should commit to spend the time necessary to adequately consider this information.

In this regard, the importance of board and committee meeting agendas as information tools should not be underestimated. Agendas and the information they contain (including the order in which items are listed on an agenda) can communicate volumes to the board and committees. The distribution of agendas should be preceded by careful preparation and internal review, as well as circulation of draft agendas at an early stage. Draft committee agendas should be circulated for review and comment to the committee chair and, in the case of the board agenda, to the chairman or lead or presiding director. (Circulation of drafts to all members of a committee or the full board seems unnecessary in the ordinary course and may unduly complicate the agenda preparation process.) Given the importance of the agenda and related materials, management should be flexible and open to suggestions concerning the agenda. As indicated above, even the order in which items are shown on the agenda can have a substantive effect, since items listed toward the end of an agenda generally come up at a late stage of the meeting, when time may be pressed, thus affording less time for discussion and consideration of a particular matter.

A related organizational tool is a calendar listing the various items that must be considered by the board and each committee over the course of a fiscal year. A comprehensive calendar, particularly one that is annotated with references to the corporate governance principles, the committee charter, and/or applicable statutory, regulatory and stock exchange requirements, can help the board or a committee to focus on the matters at hand, rather than taking time to discuss a topic that should more properly be addressed at a different meeting. Like agendas, calendars should be carefully prepared and reviewed internally, circulated for review by the committee chairs (in the case of committee calendars) and the board chairman or lead or presiding director (in the case of the board calendar), and eventually sent to all directors. Consideration should be given to creating a calendar covering all committees and the board, so that members of a particular committee can be kept informed of discussions being conducted by other committees and, where appropriate, consider scheduling joint meetings or less formal discussions among members of two or more committees.

Increasingly, the means of delivering information has become very important. In an environment where directors may be traveling more than they are in their offices, some companies have implemented secure extranet sites or used other technological solutions to provide directors with access to information regardless of where they may be at any time. Other companies have found it useful to stick to the "old fashioned" way of delivering hard copy. As is the case in so many other areas, the composition of the board and the nature of the company and its industry may dictate the appropriate practice. Often, the corporate secretary is the proper person to organize materials being furnished to the board, to review the material to assure that it is comprehensive, comprehensible and balanced, and to make sure that it is delivered to directors in a timely manner.³

Of course, directors today need more than board and committee agendas and related materials. Increasingly, companies keep their directors current on developments in and affecting the company by periodic letters, analyst reports, shareholder lists, trading patterns, and other materials, often by e-mail. As this list of materials suggests, it is important--particularly in an era of shareholder activism--that directors receive not only materials prepared by the

company, but also materials prepared by company outsiders, such as institutional and other investors, rating agencies, and analysts. A concerted effort should be made to assure that directors see both good and bad news; often, directors need to know about unfavorable reports in the media more than they do about "good" news. In addition, when a development is particularly significant, it may be desirable to contact directors by telephone.

Many companies have found it useful in connection with board self-evaluations or otherwise to ask their directors the types of information they would like to receive and the frequency with which they would like to receive it. A partnership between the corporate secretary and the media and investor relations departments, as well as the finance/accounting function (which customarily generates much of the information provided to the board), that takes the directors' preferences into account, can be very effective in assuring that directors get the right information in a timely manner.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityMeetingsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityMeetingsProcedures

FOOTNOTES:

(n1)Footnote 1. For a discussion of the importance of directors having an extensive understanding of the corporation and its business, see John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421 (Feb. 2004).

(n2)Footnote 2. Colin B. Carter and Jay W. Lorsch, *Back to the Drawing Board* 150-151 (2004).

(n3)Footnote 3. See § 14.04[2] below, discussing the corporate secretary's role with respect to board information.



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

1-7 Corporate Governance: Law and Practice § 7.08

AUTHOR: Robert B. Lamm

§ 7.08 Executive Sessions

For many years, some boards of directors have provided an opportunity for the non-management directors to meet outside the presence of management in executive sessions. Now, the NYSE corporate governance listing standards require that the non-management directors of each company meet in regularly scheduled executive sessions without management¹ and suggest that "if that group includes directors who are not independent ..., listed companies should at least once a year schedule an executive session including only independent directors."² The NYSE further requires that the director who presides at these sessions be disclosed in the company's annual proxy statement or Form 10-K.³ Alternatively, a company must disclose the procedure by which a presiding director is selected for each executive session.⁴ NASDAQ also requires that independent directors have regularly scheduled meetings at which only independent directors are present, but it does not specify who is to preside at such meetings.⁵

If a company has a non-executive chairman or a lead or presiding director, that individual should chair executive sessions of the board. If no such person has been designated, one director can be designated to chair these sessions, or the responsibility can be rotated among the chairs of the principal board committees or, possibly, other directors (in part depending upon the subjects discussed during the session). However, rotation is not considered a best practice by many institutional investors and others. Governance commentators generally agree, however, that it is preferable for one director--rather than a committee or other group of directors--to chair executive sessions.

The requirement to hold executive sessions is having a significant impact on board dynamics. Many companies are scheduling executive sessions on a more frequent basis than annually--for example, several times per year or at every board meeting.⁶ Some commentators advise that executive sessions "should be scheduled as part of the board's routine so they will not cause undue angst for the CEO and his management team."⁷

In order for these sessions to be effective, feedback should be provided to the CEO.⁸ This can be done by the lead or presiding director or the director that presided over the particular session or by the whole board.

Notwithstanding their limited attendance, the discussion at executive sessions should be reflected in the minutes, albeit in a general manner. The corporate secretary should "debrief" the leader of the session to determine the broad topics that were discussed and any actions taken⁹ (and the minutes should note that the secretary was not present and the person

on whom he/she is relying for the description). However, to assure that the executive session is characterized by the requisite degree of candor, and to preserve the relatively confidential nature of these sessions, the minutes of executive sessions should ordinarily be substantially less detailed than "regular" board minutes, possibly by doing no more than describing the issues discussed and providing only limited details of the discussion. Some commentators have suggested that the minutes should do no more than state that an executive session took place.¹⁰

A related question is the extent to which matters to be covered in the executive session should be listed in the agenda for the meeting. As indicated above with respect to minutes, if a matter to be covered in executive session is particularly sensitive, it may be desirable to omit any reference to it in the agenda (though in that case it may be advisable to informally advise the members of the board or committee that the matter may be discussed, so that they can consider the matter in advance). However, absent concerns as to confidentiality and the like, it can be helpful to list in the agenda the matters to be discussed in executive session; aside from giving the directors a "heads-up" on the matter, doing so can help with the logistics of the executive session, so that the appropriate persons can enter and leave the meeting on a more orderly basis.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority Meetings General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority Meetings Procedures Business & Corporate Law Corporations Directors & Officers Scope of Authority Meetings Special Meetings Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. NYSE Listed Company Manual § 303A.03.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.03 Commentary.

(n3)Footnote 3. NYSE Listed Company Manual § 303A.03 Commentary. To the NYSE corporate governance listing standards specifically require that a non-management director preside over each executive session of non-management directors, although the same director need not preside over all such sessions.

(n4)Footnote 4. NYSE Listed Company Manual § 303A.03 Commentary. For example, some companies rotate the presiding director position among the chairs of board committees.

(n5)Footnote 5. Nasdaq Rule 4350(c)(2).

(n6)Footnote 6. *See, e.g.*, Business Roundtable Corporate Governance Survey (Dec. 2008) Press Release, reporting that 75% of the boards surveyed, and 92% of the compensation committees surveyed, meet in executive session at every meeting *available at* www.businessroundtable.org.

(n7)Footnote 7. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 195 (2004).

(n8)Footnote 8. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 195 (2004).

(n9)Footnote 9. While it is unusual for action to be taken at executive sessions of the non-management or independent directors, action may more often be taken at executive sessions of Board committees--which topic is beyond the focus of this chapter.

(n10)Footnote 10. *See* Carpenter, "Directors Told to Ask Probing Questions, Set Up Ground Rules for Executive Sessions," BNA Corporate Accountability Report, Vol. 3, No. 43 (November 4, 2005).



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CHAPTER 7 BOARD STRUCTURE AND PROCESSES

*1-7 Corporate Governance: Law and Practice § 7.09***AUTHOR:** Robert B. Lamm**§ 7.09 Use of Outside Advisors**

Traditionally, boards and board committees have relied on advice provided by the company's counsel and other experts. Post-Sarbanes-Oxley, however, a small, but growing, number of boards and board committees are seeking independent advice on a more frequent or regular basis. In this regard, Section 301 of the Sarbanes-Oxley Act and related SEC, NYSE and NASDAQ rules¹ require that audit committees have authority to engage independent counsel and other advisers. In addition, the commentary to the NYSE's listing standards states that the compensation committee should have sole authority to retain and terminate consulting firms² and the nominating/corporate governance committee should have sole authority to retain and terminate director search firms.³ While these provisions reinforce the use of outside advisors by independent board members, boards have sought legal counsel and other forms of advice on many occasions in the past. For example, boards have sought independent advice when conducting investigations or when directors find it necessary to educate themselves on a particular topic. In addition, compensation committees have routinely used compensation consultants on an annual or other periodic basis to help evaluate plans and other incentives. However, as a result of the Sarbanes-Oxley Act, the NYSE standards, or otherwise, directors, particularly members of audit committees, are considering the use of outside advisors on a more regular basis.

The availability of outside counsel and other advisors on an "as needed" basis is an important component of director independence; a director who knows that he or she can obtain independent legal or other advice when circumstances warrant--including to resolve uncertainties on the part of the director about his or her own course of action--is less likely to be subject to CEO or other management influence. In some cases, this result can be achieved by having regular outside counsel meet and interact with the board--including by attending meetings--so that the board (rather than merely the CEO or the general counsel) can feel safe in relying upon outside counsel's advice. Depending upon the circumstances, however, the use of full-time "general" advisors by the independent directors or board committees--as distinguished from using advisors for specific, limited purposes (such as serving as a "second set of eyes" to review major SEC filings)--could raise concerns regarding board culture and the relationship between the board and management. First, a board that uses outside advisors on a continuous basis with the goal of constantly testing management's assertions (whatever the specific form of the advisory relationship) may be giving a not so subtle hint that it does not trust management; if that is the case, it may be preferable to change management rather than constantly second-guess it. Second, directors who retain advisors should be aware that doing so does not free the director from responsibility; a director cannot abdicate his or her responsibility merely by bringing in outsiders. However, state law

generally does permit a director to rely upon legal counsel, accountants or other persons as to matters the director reasonably believes to be within the person's professional or expert competence.ⁿ⁴

In addition, institutional owners and others have expressed concerns regarding the independence of compensation consultants and other outside advisors to the board and committees. For example, if a firm that provides consulting advice to a compensation committee is at the same time providing substantial services to management, the willingness of the firm to render independent advice to the committee may be called into question. For that reason, some companies have policies, and provide disclosure, concerning the independence of outside advisors to their boards and committees, and the SEC has stated that it is considering greater disclosure concerning conflicts of interest on the part of compensation consultants.ⁿ⁵

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. 1934 Act Rule 10A-3; NYSE Listed Company Manual § 303A.06; Nasdaq Rule 4350(d).

(n2)Footnote 2. NYSE Listed Company Manual § 303A.05 Commentary.

(n3)Footnote 3. NYSE Listed Company Manual § 303A.04 Commentary.

(n4)Footnote 4. *See Del. Code Ann. tit. 8, § 141(e)* (2003).

(n5)Footnote 5. <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.



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CHAPTER 8 THE NOMINATING AND CORPORATE GOVERNANCE COMMITTEE

1-8 Corporate Governance: Law and Practice 8.syn

AUTHOR: John F. Olson Ashley Wright

§ 8.syn Synopsis to Chapter 8: THE NOMINATING AND CORPORATE GOVERNANCE COMMITTEE

§ 8.01 Evolution of the Nominating/Corporate Governance Committee

§ 8.02 Composition of the Nominating/Corporate Governance Committee

[1] NYSE Independence Criteria for Nominating/Corporate Governance Committee Membership

[2] NASDAQ Independence Criteria for Nominating/Corporate Governance Committee Membership

§ 8.03 Nominating/Corporate Governance Committee Duties and Responsibilities

[1] Identifying, Evaluating and Recommending Candidates for Board Membership

[a] Criteria for Identifying and Evaluating Director Candidates

[i] NYSE and SEC Requirements

[ii] Key Criteria

[b] Identifying and Recruiting New Candidates

[c] Evaluating Incumbent Directors

[d] Shareholder Participation in the Director Selection Process

[i] Suggesting Candidates to the Nominating/Corporate Governance Committee

[ii] Shareholder Access to Company Proxy Statements

[iii] Majority Voting Standard in Director Elections

[2] Reviewing the Structure, Composition and Functioning of the Board and Its Committees

- [a] Board Independence
- [b] Recommending Candidates for Board Committees
- [c] Board Retirement and Tenure Policies
- [d] Other Directorships
- [e] Board Processes
- [f] Director Orientation and Training
- [g] Director Compensation
- [h] Board and Committee Evaluations

[3] Developing and Reviewing Corporate Governance Guidelines

[4] Reviewing the Company's Succession Plans

[5] Shared Functions

- [a] Management Evaluations
- [b] Legal Compliance
- [c] Risk Assessment and Risk Management

John F. Olson
Ashley Wright n*

FOOTNOTES:

(n1)Footnote *. Robert Lindsey, an associate at Gibson, Dunn & Crutcher LLP assisted in the preparation of the 2010 supplement.



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CHAPTER 8 THE NOMINATING AND CORPORATE GOVERNANCE COMMITTEE

1-8 Corporate Governance: Law and Practice § 8.01

AUTHOR: John F. Olson Ashley Wright

§ 8.01 Evolution of the Nominating/Corporate Governance Committee

Historically, the nominating committee of the board of directors had one purpose: to identify, evaluate, and recommend director candidates to the full board. Regarded by some as little more than a "rubber stamp" for director choices submitted by the CEO,ⁿ¹ the traditional nominating committee did not play a central part in other aspects of corporate governance. Over the past decade, however, the nominating committee's responsibilities have broadened significantly so that today, at many companies, the committee has a leadership role in shaping corporate governance.ⁿ² Typically included among the committee's expanded duties are:

- reviewing and making recommendations concerning the structure, composition, independence and functioning of the board and its committees;
- developing a set of corporate governance principles for the company;
- planning for CEO and senior management succession; and
- at some companies, overseeing management evaluations and contributing (with the audit committee) to oversight of legal compliance and risk management.

Both the NYSE and NASDAQ have defined nominating committee responsibilities in their corporate governance listing standards.ⁿ³ The NYSE and NASDAQ requirements for nominating committees are discussed in more detail below.ⁿ⁴

The name of the nominating committee also has changed at many companies, reflecting its additional responsibilities. Names used by companies today include the Nominating and Corporate Governance Committee; the Nominating, Governance and Corporate Responsibility Committee; the Board Policy and Nominating Committee; the Nominating and Directors Committee; the Corporate Governance Committee; and the Board Affairs and Nominating Committee.ⁿ⁵

According to an Institutional Shareholder Services ("ISS") study published in 2007, 98 percent of the S&P Super 1,500 companies surveyed have a board committee charged with nominating responsibilities, up from 74 percent in 2002 and 66 percent in 1999.ⁿ⁶ ISS also found that 95 percent of companies--more than double the number in 2002--have a

committee handling corporate governance matters.ⁿ⁷ As discussed above, most boards combine the nominating and corporate governance functions in a single committee and ISS found that as of 2008, 97 percent of companies report having one of their committees responsible for reviewing the size, composition and performance of the board.ⁿ⁸

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law
 Corporations
 Directors & Officers
 Scope of Authority
 Discretion
 Business & Corporate Law
 Corporations
 Directors & Officers
 Terms in Office
 General Overview
 Business & Corporate Law
 Corporations
 Governing Documents & Procedures
 General Overview
 Securities Law
 Self-Regulating Entities
 National Association of Securities Dealers
 Securities Law
 Self-Regulating Entities
 National Securities Exchanges
 New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* Richard F. Kotz, *The Modern Nominating Committee*, 6 Corp. Governance Advisor 4, 1 (1998).

(n2)Footnote 2. *See* Business Roundtable, *Principles of Corporate Governance* 2005, 21 (Nov. 2005).

(n3)Footnote 3. Under NASDAQ listing standards, a separate committee need not be formed; rather, a majority of the independent directors may perform the functions of the nominating committee.

(n4)Footnote 4. *See* § 8.02 and § 8.03 *below*.

(n5)Footnote 5. *See* Richard F. Kotz, *The Modern Nominating Committee*, 6 Corp. Governance Advisor 4, 4 (1998); American Bar Association Committee on Corporate Laws, *Corporate Director's Guidebook* 81 (5th ed. 2007) [hereinafter ABA Corporate Director's Guidebook].

(n6)Footnote 6. *See* Institutional Shareholder Services, 2008 Background Report: The Election of Directors, Board Independence and Related Issues 5 (2008).

(n7)Footnote 7. *See* Institutional Shareholder Services, 2007 Background Report; The Election of Directors, Board Independence and Related Issues 19 (2007).

(n8)Footnote 8. *See* Institutional Shareholder Services, 2008 Background Report; The Election of Directors, Board Independence and Related Issues 5 (2008).



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CHAPTER 8 THE NOMINATING AND CORPORATE GOVERNANCE COMMITTEE

1-8 Corporate Governance: Law and Practice § 8.02

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§ 8.02 Composition of the Nominating/Corporate Governance Committee

Traditionally, it was not unusual for the CEO or other members of management to serve on the nominating committee. As recently as 1990, only 16 percent of large companies surveyed by the Investor Responsibility Research Center barred insiders from sitting on their nominating committees.ⁿ¹ Today, however, far fewer company insiders serve on nominating/corporate governance committees. In fact, companies have made significant efforts in recent years to increase the number of independent directors on nominating/corporate governance committees. According to ISS, the average independence level of nominating committees stood at 94 percent in 2007, up from 93 percent the prior year, with the prevalence of fully independent nominating committees increasing to 87 percent from 82 percent the prior year.ⁿ² Under NYSE and NASDAQ corporate governance listing standards, *all* members of the nominating committee must be independent.ⁿ³

[1] NYSE Independence Criteria for Nominating/Corporate Governance Committee Membership

Under the NYSE's definition of "independent director," no director may qualify as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company. Under the NYSE's definition of "independent director," no director may qualify as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company.ⁿ⁴ In addition:

- a director who is an employee, or whose immediate family member is an executive officer of the listed company is not independent until three years after the end of such employment relationship;ⁿ⁵
- a director who receives, or whose immediate family member receives, more than \$120,000 during any 12-month period in direct compensation from the listed company, other than director and committee fees and pension or other deferred compensation for prior service, is not independent until three years after he or she ceases to receive more than \$120,000 in such compensation;ⁿ⁶
- a director who is a current partner or a current employee of the firm that is the company's internal or

external auditor, or whose immediate family member is (1) a current partner of such firm, or (2) a current employee of the firm and personally works on the listed company's audit, is not independent;ⁿ⁷

- a director who was, or whose immediate family member was, within the last three years a partner or employee of the company's internal or external auditor and who worked on the company's audit within that time is not independent;ⁿ⁸

- a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's current executive officers serve on the compensation committee is not independent until three years after the end of such relationship;ⁿ⁹ and

- a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of \$1 million or 2 percent of such other company's consolidated gross revenues, is not independent.ⁿ¹⁰

Directors who fail to qualify as "independent" under these tests may not serve on a listed company's nominating/corporate governance committee under the NYSE listing standards.

The NYSE has a practice of reviewing, and commenting on, the proxy statements of its listed companies, focusing in particular on directors' biographical information and related-party transactions. If the NYSE believes that a director who is described as independent is not, in fact, "independent" under NYSE standards, or if in the view of NYSE staff a company has not adequately described how its board makes independence determinations, the listed company may receive a call or letter from its NYSE representative.ⁿ¹¹ Unlike SEC reviews, this NYSE review will occur after the proxy statement has been mailed, and requested changes will apply to subsequent years.

[2] NASDAQ Independence Criteria for Nominating/Corporate Governance Committee Membership

NASDAQ's corporate governance listing standards provide that director nominees must be selected, or recommended for the board's selection, either by a majority of independent directors or by a nominations committee composed solely of independent directors.ⁿ¹² The NASDAQ standards define an "independent director" as a person other than an executive officer or employee of the company or any other individual having a relationship that, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.ⁿ¹³

According to commentary accompanying the NASDAQ standards, the board is responsible for making an "affirmative determination" that individuals serving as independent directors do not have a relationship with the listed company that would impair their independence.ⁿ¹⁴ In this regard, the NASDAQ standards set forth a list of relationships that would preclude a board finding of independence. Under the NASDAQ standards, the following persons would not be considered independent:

- a director who is, or during the past three years was, employed by the company;

- a director who accepted, or who has a family member who accepted, any compensation from the company in excess of \$120,000 during any period of 12 consecutive months within the three years preceding the determination of independence, other than compensation for board or committee service, compensation paid to a family member who is employed by the company (but not as an executive officer), or benefits under a tax-qualified retirement plan or non-discretionary compensation;

- a director whose family member is, or during the past three years was, employed by the company as

an executive officer;

- a director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services that exceed 5 percent of the recipient's consolidated gross revenues or \$200,000 (whichever is greater) in the current fiscal year or any of the past three fiscal years, other than payments arising solely from investments in the company's securities or payments under non-discretionary charitable contribution matching programs;

- a director who is, or has a family member who is, employed as an executive officer of another entity where an executive officer of the listed company serves on the compensation committee (or if such relationship existed during the past three years); and

- a director who is, or has a family member who is, a current partner of the listed company's outside auditor, or was a partner or employee of the outside auditor who worked on the company's audit during the past three years.¹⁵

Commentary to the NASDAQ listing standards states that independent director oversight of nominations "enhances investor confidence in the selection of well-qualified director nominees, as well as independent nominees as required by" other NASDAQ listing standards.¹⁶ The commentary also indicates that the NASDAQ standards are "intended to provide flexibility for a company to choose an appropriate board structure and reduce resource burdens, while ensuring that independent directors approve all nominations."¹⁷

Notwithstanding this requirement, the NASDAQ standards permit one non-independent director to serve on the nominating/corporate governance committee for up to two years if:

- (1) the nominating/corporate governance committee is composed of at least three members;
- (2) the director is not a current officer or employee (or a family member of an officer or employee) of the listed company;
- (3) the board, under "exceptional and limited circumstances, determines that [the director's] membership on the committee is required by the best interests of the company and its shareholders"; and
- (4) the board discloses, in the company's next proxy statement, the nature of the relationship and the reasons for the determination.¹⁸

In addition, under both NYSE and NASDAQ listing standards, independent director oversight of director nominations is not required in cases where the right to nominate a director legally belongs to a third party, or where the company is subject to a binding obligation requiring a director nomination structure inconsistent with the standards.¹⁹

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion Business & Corporate Law Corporations Directors & Officers Terms in Office General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* Stuart Mieher, *Revised Rules of the Corporate Game: Firms Restrict CEOs in Picking Board Members*, Wall St. J., Mar. 15, 1993, at B1.

(n2)Footnote 2. *See* Institutional Shareholder Services, 2007 Background Report: The Election of Directors, Board Independence and Related Issues 18 (2007). ISS defines an independent director as one who is neither an employee of the company nor affiliated with it other than through the directorship.

(n3)Footnote 3. *See* NYSE Listed Company Manual § 303A.04(a); NASDAQ Rule 5605(e). As noted above, a majority of the independent directors may perform the functions of an independent nominating committee under the NASDAQ standards. NASDAQ also provides a limited exception for one non-independent director to serve on the nominating committee, as discussed in § 8.02[2] below.

(n4)Footnote 4. *See* NYSE Listed Company Manual § 303A.02(a). The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n5)Footnote 5. *See* NYSE Listed Company Manual § 303A.02(b)(i).

(n6)Footnote 6. *See* NYSE Listed Company Manual § 303A.02(b)(ii). Compensation received by an immediate family member for service as a non-executive employee need not be considered under this test. *See* NYSE Listed Company Manual § 303A.02(b)(ii) Commentary.

(n7)Footnote 7. *See* NYSE Listed Company Manual § 303A.02(b)(iii)(A), (B), (C).

(n8)Footnote 8. *See* NYSE Listed Company Manual § 303A.02(b)(iii)(D).

(n9)Footnote 9. *See* NYSE Listed Company Manual § 303A.02(b)(iv).

(n10)Footnote 10. *See* NYSE Listed Company Manual § 303A.02(b)(v).

(n11)Footnote 11. *See, e.g.*, Davis Polk & Wardwell, Corporate Regulatory Report (Aug. 2005).

(n12)Footnote 12. *See* NASDAQ Rule 5605(e). NASDAQ Rule 5605 and related interpretations, IM-5605-7, are reproduced in Appendix C to this treatise.

(n13)Footnote 13. *See* NASDAQ Rule 5605(a)(2). NASDAQ Rule 5605(a)(2) and the related interpretation, IM-5605, are reproduced in Appendix C to this treatise.

(n14)Footnote 14. Commentary to NASDAQ Rule 5605(a)(2), IM-5605.

(n15)Footnote 15. *See* NASDAQ Rule 5605(a)(2).

(n16)Footnote 16. Commentary to NASDAQ Rule 5605(e), IM-5605-7.

(n17)Footnote 17. Commentary to NASDAQ Rule 5605(e), IM-5605-7.

(n18)Footnote 18. NASDAQ Rule 5605(e)(3).

(n19)Footnote 19. *See* NYSE Listed Company Manual § 303A.04 Commentary; NASDAQ Rule 5605(e)(4), (5).



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CHAPTER 8 THE NOMINATING AND CORPORATE GOVERNANCE COMMITTEE

1-8 Corporate Governance: Law and Practice § 8.03

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§ 8.03 Nominating/Corporate Governance Committee Duties and Responsibilities

[1] Identifying, Evaluating and Recommending Candidates for Board Membership

[a] Criteria for Identifying and Evaluating Director Candidates

[i] NYSE and SEC Requirements

One of the nominating/corporate governance committee's primary responsibilities is recommending director candidates to the full board for inclusion in the company's proxy materials or to fill interim vacancies on the board. To perform this function properly, the nominating/corporate governance committee should develop written criteria for identifying and evaluating director candidates.ⁿ¹ In this regard, the NYSE corporate governance listing standards provide that the nominating/corporate governance committee's purpose and responsibilities must include identifying individuals qualified to become board members, "consistent with criteria approved by the board."ⁿ²

Under SEC rules, companies must provide detailed disclosure regarding nominating committees and nominating committee processes, including the committee's minimum criteria for selecting director nominees.ⁿ³ Specifically, the rules require a company to disclose in its proxy statement:ⁿ⁴

- whether it has a separate nominating committee and if not, why not and who determines nominees for director;
- whether the nominating committee has a charter and if so, whether a current copy of the charter is available on the company's website (and the website address);ⁿ⁵
- the name of any nominating committee member who is not independent, as independence is defined by the company in compliance with the listing standards of the relevant national securities market;
- whether the nominating committee has a policy regarding the consideration of director candidates recommended by shareholders and:

- if not, why not; or

- if so, a description of the material elements of the policy, including a statement as to whether the committee will consider director candidates recommended by shareholders and the procedures to be followed by shareholders in submitting recommendations (any material changes to these procedures must be disclosed in the company's periodic reports on Forms 10-Q and 10-K);

- any specific, minimum qualifications that the nominating committee believes must be met by nominating committee-recommended nominees, and any specific qualities or skills that the committee believes are necessary for one or more of the company's directors to possess;
- the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by shareholders, and any differences in the manner in which the committee evaluates nominees based on whether they are recommended by a shareholder;
- which "category" of person(s) recommended each new nominee approved by the nominating committee (categories include shareholders, non-management directors, the chief executive officer, other executive officers, third-party search firms and other, specified sources);
- if the company pays any third party a fee to assist in identifying or evaluating potential nominees, the function performed by the third party; and
- if the nominating committee received a nominee from a long-term, more than 5-percent shareholder or group of shareholders, the names of the candidate and the shareholder or shareholder group and whether the nominating committee chose to nominate the candidate (provided that no such identification or disclosure is required unless both the shareholder and the candidate consent).

In addition to these disclosures, SEC Chairman Schapiro has stated that, "the Commission will consider whether to enhance disclosure around director nominee experience, qualifications and skills."⁶ And at an open meeting held on July 1, 2009, the Securities and Exchange Commission proposed several rule changes to improve disclosures about compensation and corporate governance matters.⁷ Specifically, the proposed changes would:

- Amend Item 401 of Regulation S-K to require that companies provide disclosure about (1) the experience, qualifications, attributes and skills of directors and director nominees that qualify them to serve as a director and as a member of each committee on which they serve, (2) all public company directorships held by directors and director nominees during the past five years, as opposed to just current directorships (as required under the current rules), and (3) the involvement of directors, director nominees and executive officers in legal proceedings during the prior ten years, as opposed to five years (as required under the current rules); and
- Amend Item 407 of Regulation S-K to require disclosure about a company's board leadership structure and why the structure is appropriate for the company. The proposed disclosure would need to include a discussion of whether the company separates or combines the roles of the chairman and chief executive officer, whether the company has a lead independent director, the board's role in the company's risk-management process and the effects, if any, that this role has on the company's board leadership structure.

Under existing SEC rules, companies generally disclose if they have standing nominating/corporate governance committees and whether such committees will consider director candidates recommended by shareholders. In fact, 93

percent of nominating/corporate governance committees surveyed by Business Roundtable in 2006 reported that they were willing to consider shareholder nominations, up from 85 percent in 2005.ⁿ⁸ Many companies have disclosed that they will consider shareholder-recommended candidates using the same criteria they use for candidates from other sources. Companies have also specified what information shareholders should provide when they recommend director candidates (by, for example, referring to the SEC's proxy disclosure requirements or indicating that shareholders should provide a candidate's name, address, biographical information, resume and consent to serve if elected).

[ii] Key Criteria

Important attributes of an effective corporate director include "strength of character, an inquiring and independent mind, practical wisdom and mature judgment,"ⁿ⁹ as well as candor and the ability--and willingness--to learn about and understand the business of the company.ⁿ¹⁰ Depending on the company's circumstances and needs, director qualifications also may include relevant business and industry experience, technical knowledge and financial literacy or expertise, particularly if the director candidate is slated to become a member of the audit committee.ⁿ¹¹ A candidate's prior success as a manager or director of another company or significant enterprise also may be relevant.

In recent years, some companies have added ethnicity and gender to their list of director considerations,ⁿ¹² and large institutional investors have encouraged the companies in which they invest to recruit more qualified women and minority board candidates and to formalize their commitment to board diversity.ⁿ¹³ A study published by Institutional Shareholder Services ("ISS") in 2007 found a gradual trend in the diversification of boards between 2000 and 2006. In 2008, more than 70 percent of companies surveyed by the ISS included at least one woman on their board, and 37 percent disclosed that they had at least one minority director.ⁿ¹⁴

The nominating/corporate governance committee's criteria for board membership should take into account the composition of the full board, which should reflect a range of abilities, experience and perspectives appropriate to the company's circumstances.ⁿ¹⁵ Directors need not all have the same expertise; those with less knowledge in a certain area should be able to trust the judgment of others with more experience in that area.ⁿ¹⁶ For example, the nominating/corporate governance committee could decide that the board needs to have specified numbers of directors with experience in compliance and legal matters, directors who understand financial reporting and complex accounting issues and directors with experience in managing risk and developing corporate strategy, in addition to CEOs and other senior executives who are familiar with the company's industry and customers.ⁿ¹⁷ Moreover, recently directors' industry experience has become a focus as a result of the upheavals in the banking industry. Banks were criticized for the number of board members serving without finance experience and subsequently, it has been reported that regulators have been strongly urging banks to address this shortcoming in finance experience.ⁿ¹⁸

The committee also should consider the independence of the board and key board committees when developing criteria for board membership. Both the NYSE and NASDAQ require that listed company boards have a majority of independent directors.ⁿ¹⁹ Many commentators have gone further, recommending that public company boards be composed of a "substantial majority" of independent directors,ⁿ²⁰ and many companies have implemented this recommendation. In December 2008, for example, 90 percent of companies surveyed by Business Roundtable reported that their boards were at least 80 percent independent.ⁿ²¹ A broader survey of S&P 1,500 companies found that just over 78 percent of such companies had boards that were at least two-thirds independent in 2007, an almost 7 percent increase from 2006.ⁿ²²

The NYSE and NASDAQ definitions of "independence"ⁿ²³ focus principally on employment, family, and business relationships. As many companies have recognized, however, other kinds of relationships, including charitable donations and personal relationships between directors and senior management, may affect a director's actual or perceived independence.ⁿ²⁴ Moreover, SEC rules now require disclosure, for each) director and nominee for director who is identified as independent, of any transactions, relationships or arrangements that were considered by the board under the applicable independence definitions but were not disclosed pursuant to the SEC's related-party transaction

rules.ⁿ²⁵ Finally, even a director with no visible ties to management is not truly "independent" if he or she is unable or unwilling to consider matters before the board with objectivity and impartiality, exercise independent judgment about management's actions and competence, challenge management's ideas and vote against them when warranted, and commit to review and discuss all proposals of importance to the company.ⁿ²⁶

The nominating/corporate governance committee also should consider the criteria applied by proxy voting advisory services, such as ISS and Glass Lewis & Co., in evaluating director independence. In many ways, these criteria go beyond NYSE and NASDAQ independence standards. For example, ISS looks at directors' employment relationships with "affiliates," which include "sibling companies" in addition to parent companies and subsidiaries, and it treats former executives of the company or its affiliates as *per se* not independent for at least five years after employment ends. In addition, ISS considers relatives of non-executive employees of the company or its affiliates not to be independent under certain circumstances, such as where a director is related to numerous employees, where the company employs relatives of numerous directors, or where a director's relative serves in a key strategic (but not executive) role.ⁿ²⁷ It is important for the nominating/corporate governance committee to take these criteria into account, as ISS will recommend that shareholders withhold votes from or vote against directors who do not meet ISS independence standards and who serve on the company's audit, compensation or nominating committees. Withhold votes for directors have become more significant as more companies have moved from plurality voting to a majority voting standard in director elections or adopted director resignation policies, as discussed below.ⁿ²⁸

This said, the nominating/corporate governance committee should not regard independence as the singular director virtue, to the neglect of other important qualities.ⁿ²⁹ In fact, some boards may be more effective when they include members of management and other non-independent directors who have a more comprehensive understanding of the company and its business, strategy and risks.ⁿ³⁰ The nominating/corporate governance committee should consider the appropriate mix of independent, non-independent and management directors when developing criteria for board membership and selecting director nominees.

[b] Identifying and Recruiting New Candidates

As discussed above, the SEC is considering amendments to Item 401 of Regulation S-K to enhance disclosure requirements for director qualifications. In light of these proposed, enhanced disclosure requirements, the committee will want to focus particularly on identifying, evaluating and recruiting qualified new candidates to the board are key functions of the nominating/corporate governance committee. In this regard, the NYSE's corporate governance listing standards provide that the nominating/corporate governance committee's purpose and responsibilities must include identifying individuals qualified to become board members and selecting, or recommending that the board select, the director nominees for the next annual meeting of shareholders.ⁿ³¹ In addition, as noted above,ⁿ³² SEC rules require detailed disclosure concerning nominating/corporate governance committees and their procedures for selecting director candidates.ⁿ³³ Commonly disclosed procedures for selecting new directors include defining specific qualifications for board membership; accepting recommendations from directors, management, shareholders and others; and retaining executive search firms to identify and recruit new candidates.

When beginning a search for new directors, the nominating/corporate governance committee should focus on its criteria for board membership and any skills or perspectives that the board currently lacks or needs to enhance.ⁿ³⁴ In this regard, the board may find it useful to prepare a matrix of necessary board skills, rating current directors' competencies in each area and identifying the areas in which additional expertise is needed.ⁿ³⁵ After the desired skill set has been identified, the nominating/corporate governance committee can prepare a "job description" to use in evaluating potential candidates.

The committee also should think about the group dynamic of the board, with the goal of selecting individuals who can contribute to the board and enhance that dynamic.ⁿ³⁶ A candidate's ability to work well with the other directors and the CEO will play a major part in determining his or her effectiveness on the board.ⁿ³⁷

The nominating/corporate governance committee should consider candidates with a variety of backgrounds, including the public sector, educational and not-for-profit institutions and senior management in addition to current and former CEOs.ⁿ³⁸ In recent years, some nominating/corporate governance committees have hired executive search firms to assist them in identifying and recruiting new candidates. Using an executive search firm may give the committee a larger, more diverse pool of potential candidates to consider, resulting in greater selectivity. It also may reduce the burden on the company's directors and human resources department to identify and recruit new candidates.ⁿ³⁹ Finally, using an outside firm may decrease bias (or the appearance of bias) by diminishing the influence of management or current directors in the process.

The NYSE's corporate governance listing standards recommend that the nominating/corporate governance committee be given "sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms."ⁿ⁴⁰ According to the NYSE, this authority should be set forth in the nominating/corporate governance committee's charter.ⁿ⁴¹

The nominating/corporate governance committee should make the ultimate determination of which candidates to recommend to the board, although all directors, the CEO and management should be encouraged to meet with director candidates and provide input to the committee.ⁿ⁴² The committee also should invite, and seriously consider, suggestions from shareholders regarding board composition and potential board nominees.ⁿ⁴³ The role of shareholders in the nomination process is discussed in more detail below.

Once the board has selected a candidate for nomination, the chair of the nominating/corporate governance committee should contact the candidate and request that he or she accept the nomination. This may be done in conjunction with the CEO, but in order to avoid any appearance that the CEO controls the nomination process, it should not be done by the CEO alone.

[c] Evaluating Incumbent Directors

In addition to identifying and recruiting new director candidates, the nominating/corporate governance committee is responsible for evaluating the contributions of incumbent directors and deciding whether to recommend those directors for re-nomination. This is an important obligation; neither directors nor the nominating/corporate governance committee should regard re-nomination as automatic. On the contrary, directors should serve only so long as they add value to the board, and a director's contributions to the board and the company should be honestly assessed every time he or she is evaluated for re-nomination.ⁿ⁴⁴

As a director's term nears its end, the nominating/corporate governance committee should review and evaluate that director's contributions to the board, as well as the board's criteria for membership and the company's continuing needs.ⁿ⁴⁵ Where all directors are elected annually, this means that the committee should evaluate the performance of each director each year. Individual director evaluations are becoming more common. According to a 2006 Business Roundtable survey, 38 percent of companies surveyed performed individual director evaluations in 2005, and 45 percent were planning to do so in 2006.ⁿ⁴⁶ In addition, nearly every company (98 percent) responding to a 2004 Business Roundtable survey had a procedure in place for reviewing or analyzing incumbent directors in connection with their re-nomination.ⁿ⁴⁷

To assist the nominating/corporate governance committee in the evaluation process, some committees require confidential director self-evaluations and/or peer evaluations.ⁿ⁴⁸ These evaluations, which may be administered by the committee, in-house personnel or a third party, typically ask directors to rate themselves and fellow directors in a number of areas, including meeting attendance, preparation and participation; understanding of the company's business and strategy; contributions to the board's governance responsibilities; support outside of meetings (including assistance in recruiting and retaining key personnel); and willingness to ask difficult questions and challenge management's

assumptions.ⁿ⁴⁹ Other committees prefer a more informal process of discussions led by the board chair, the chair of the nominating/corporate governance committee or an outside facilitator. Individual director evaluations may be combined with board and committee evaluations, discussed below.ⁿ⁵⁰

The nominating/corporate governance committee or its chair should provide appropriate feedback to directors whose performance evaluation raises concerns.ⁿ⁵¹ If the nominating/corporate governance committee decides *not* to recommend an incumbent director for re-nomination, that decision should be conveyed privately to the director to give him or her an opportunity to withdraw from consideration by the board.ⁿ⁵²

[d] Shareholder Participation in the Director Selection Process

[i] Suggesting Candidates to the Nominating/Corporate Governance Committee

The nominating/corporate governance committee should have a process in place for encouraging, and seriously considering, shareholder suggestions for board nominees.ⁿ⁵³ This process should be distinguished from the direct nomination by shareholders of candidates for election at shareholder meetings, where shareholders generally must comply with advance notice and nomination procedures in the company's bylaws.ⁿ⁵⁴

As discussed above,ⁿ⁵⁵ SEC rules require a company to disclose, among other things, whether its nominating/corporate governance committee will consider director candidates recommended by shareholders and whether the committee has rejected candidates put forward by large, long-term shareholders or groups of shareholders.ⁿ⁵⁶ A great many companies (including 91 percent of companies surveyed by the Business Roundtable in March 2006)ⁿ⁵⁷ have a process in place to consider and respond to shareholder nominations of board candidates

[ii] Shareholder Access to Company Proxy Statements

On October 14, 2003, the SEC proposed rules that would significantly change the way corporate directors are nominated and elected by requiring companies to include shareholder nominees for director in company proxy materials under certain circumstances (known as "shareholder access").ⁿ⁵⁸ Under existing rules, shareholders may recommend candidates to the nominating/corporate governance committee, nominate candidates at the annual meeting of shareholders, or conduct election contests by disseminating their own proxy materials,ⁿ⁵⁹ but companies are not required to include shareholder nominees in company proxy materials.

Under the proposed rules, shareholder access would have been available only upon the occurrence of one or both of the following triggers:

- at least one of the company's director nominees received "withhold" votes from more than 35 percent of the votes cast at an annual or special meeting at which directors were elected; or
- a shareholder proposal to activate shareholder access submitted by a shareholder or group of shareholders holding more than 1 percent of the company's voting securities for one year received a majority of the votes cast.ⁿ⁶⁰

The proposed rules generated substantial controversy, with over 13,000 comments submitted to the SEC by January 2004 (the SEC's original deadline for comments was December 22, 2003). On March 10, 2004, the SEC held a public roundtable to discuss the proposed rules, and numerous additional comments were submitted in response to the roundtable discussion. By 2005, however, momentum had moved away from the shareholder access proposal, and it appeared that the SEC would not adopt final rules in this area.

In September 2006, however, the U.S. Court of Appeals for the Second Circuit revived the issue with its decision in

American Federation of State, County and Municipal Employees (AFSCME), Employees Pension Plan v. American International Group Inc. (AIG).ⁿ⁶¹ In this case, the Court considered the SEC's application of SEC Rule 14a-8, which permits companies to exclude from their proxy materials shareholder proposals that "relate to an election." The Court held that the SEC did not provide sufficient reasons for a change in its interpretation of Rule 14a-8 that viewed proposals seeking shareholder access (known as "proxy access" proposals) as "relating to an election" and thus excludable. Accordingly, the Court reinstated a lawsuit by AFSCME, which sought to include a proxy access proposal in AIG's proxy materials.

In response to the Second Circuit decision, the SEC announced that it would consider an amendment to Rule 14a-8 concerning director nominations by shareholders.ⁿ⁶² After nearly a year and several public roundtables,ⁿ⁶³ the SEC ultimately published two alternative proposals.ⁿ⁶⁴ The first proposal would affirm the SEC's historical interpretation of Rule 14a-8, pursuant to which all proxy access shareholder proposals are excludable. The first proposal also reaffirms the SEC historical position that access proposal may be excluded from company proxy statements. The second proposal would permit the *inclusion* of certain proxy access proposals if specified criteria are met. Namely, a proxy access proposal would not be excludable under the alternative proposal if:

- the proposal is binding;
- the proposal seeks to amend the company's bylaws;
- the shareholder(s) submitting the proposal have held more than 5 percent of the company's outstanding shares for at least one year;
- the shareholder(s) submitting the proposal are eligible to, and have, filed a Schedule 13G with respect to the company; and
- the proposal otherwise satisfies the requirements of Rule 14a-8.ⁿ⁶⁵

The proxy access proposal also would require disclosure of additional information by shareholder proponents and companies, including information about the proponents and any previous dealings with the company.

Comments on the SEC's two proposals were due on October 2, 2007. Both proponents and opponents of proxy access were critical of the SEC's access proposal, and, after hearings by the House Financial Services Committee on August 27, 2007, its Chairman Barney Frank, and ten Democratic colleagues, urged the SEC to delay any decision on the issues. In December 2007, the SEC adopted the proposal which sought to amend Rule 14a-8 so that shareholder nomination bylaw proposal could be excluded by a company.ⁿ⁶⁶

In April 2009, the governor of Delaware signed into law a new provision of the Delaware General Corporation Law that would give shareholders "access" to the proxy statement in director elections.ⁿ⁶⁷ This new Section 112, which becomes effective August 1, 2009, will give a Delaware corporation the ability to adopt a bylaw provision that requires the corporation to include in its proxy solicitation materials one or more individuals nominated by a shareholder.ⁿ⁶⁸ The statute allows this requirement to be subject to such procedures or conditions as may be provided in the bylaws, including the following specifically enumerated procedures and conditions:

- a provision requiring a minimum record of beneficial ownership or duration of ownership;
- a provision requiring the submission of specified information regarding the shareholder and the shareholder's nominee;
- a provision conditioning the inclusion of shareholder nominees on the number or proportion of

shareholder nominees;

- a provision precluding shareholder nominees submitted by a shareholder who has acquired or proposes to acquire a certain percentage of voting power within a certain period of time before the election of directors; and
- a provision requiring a shareholder to indemnify the corporation for losses resulting from any false or misleading information submitted in relation to a nomination.

In addition to the changes in Delaware state law, the ABA is actively considering similar shareholder access amendments to the Model Business Corporation Act, which has been adopted at least in part by 30 states.ⁿ⁶⁹

The SEC is once again considering changing its rules to adopt shareholder access. SEC Chairman Mary Schapiro stated in a 2009 speech that "the Commission will consider a proposal to ensure that a company's owners have a meaningful opportunity to nominate directors," and that such consideration will include a review of the 2003 and 2007 proposals as well as a review of the new Section 112 of the Delaware General Corporation Law.ⁿ⁷⁰ This commitment to shareholder access at the SEC is not limited to Chairman Schapiro; SEC Commissioner Aguilar has also expressed his support for "swift and bold action to give shareholders access to their company's proxy statement,"ⁿ⁷¹ and SEC Commissioner Walter has stated her desire that shareholders have "a real say in determining who will oversee management of the companies that they own."ⁿ⁷²

Accordingly, on June 10, 2009, the Securities and Exchange Commission ("SEC") released a proposal to amend the SEC's proxy rules to permit shareholders to nominate directors in a company's proxy materials.ⁿ⁷³ The proposal contains extensive requests for comment, and the SEC Commissioners have urged interested parties to provide feedback on the proposal. If adopted, the proposed rules would (1) establish a federal proxy access right pursuant to proposed Rule 14a-11 and related amendments, and (2) permit proxy access shareholder proposals pursuant to an amendment to Rule 14a-8.

Proposed Rule 14a-11 would create a federal law process for a shareholder or group of shareholders to nominate one or more directors and have those nominees included in a company's proxy materials if the shareholder or group beneficially owned a certain percentage of the company's voting shares for at least one year prior to submitting the nomination. The ownership requirements would vary depending on a company's size:

- at least 1% of voting shares for large accelerated filers and registered investment companies with net assets of \$700 million or more;
- at least 3% of voting shares for accelerated filers and registered investment companies with net assets of \$75 million or more, but less than \$700 million; and
- at least 5% of voting shares for non-accelerated filers and registered investment companies with net assets of less than \$75 million.

Nominating shareholders would be required to file a new Schedule 14N disclosing the percentage of the company's shares beneficially owned, the period of time the shares have been beneficially owned, the shareholders' intent to hold their shares through the date of the meeting and certain other information similar to that currently required in a contested election. Each year, shareholders would be permitted to include in a company's proxy materials the greater of one director nominee or a number of director nominees that equals up to 25% of the company's board. Notably, the proposed rule would not restrict the ability of shareholders to nominate directors with whom they have a relationship, and shareholder nominees would only have to satisfy the objective independence standards in applicable securities market listing standards. In addition, the SEC is proposing an exemption from the proxy rules for communications made

in connection with using proposed Rule 14a-11.

Rule 14a-8(i)(8) currently permits companies to exclude shareholder proposals related to director elections. In 2007, the SEC amended this rule to specifically permit the exclusion of proxy access shareholder proposals. Proposed amendments to Rule 14a-8(i)(8) would eliminate this basis for exclusion and require companies to include in their proxy materials proxy access shareholder proposals. These shareholder proposals would be excludable from company proxy materials if they conflicted with state law or proposed Rule 14a-11; that is, a shareholder proposal could not have the effect of preventing a shareholder or group meeting the requirements of proposed Rule 14a-11 from having its nominee included in a company's proxy materials. In addition, if the proponent of a proxy access shareholder proposal failed to satisfy the current Rule 14a-8 eligibility requirements, the proposal could be excluded.

Although the proposal release does not discuss an effective date for any final proxy access rules, in an October 2009 speech, Commissioner Walter indicated an adopting release may be considered in early 2010, but final rules would not likely be in place at the beginning of the next year's proxy season.ⁿ⁷⁴

In parallel to the push for shareholder access in Delaware and the SEC, Senator Charles Schumer of New York introduced a "Stockholder Bill of Rights" that would include a provision confirming the SEC's authority to grant shareholders proxy access and Congressman Gary Peters introduced a "Shareholder Empowerment Act" containing a similar provision.ⁿ⁷⁵ In addition, in November 2009, the House Financial Services Committee approved the Investor Protection Act of 2009 which includes a proposed amendment that reaffirms the SEC's authority to make and implement rules directed at shareholder proxy access.ⁿ⁷⁶ Also in November 2009, Senator Christopher Dodd circulated a discussion draft of the "Restoring American Financial Stability Act of 2009" which also contains a proxy access proposal.ⁿ⁷⁷

[iii] Majority Voting Standard in Director Elections

Due in large part to dissatisfaction with the complexities of the SEC's 2003 shareholder access proposal and the apparent decision of a majority of the Commission to abandon it, some shareholders and commentators began calling for a move to a majority voting standard in the election of directors.ⁿ⁷⁸ Until recently, almost all companies' directors were elected through a plurality voting structure, whereby a single affirmative vote can lead to a nominee's election--regardless of how many votes are withheld from that nominee.

According to Institutional Shareholder Services ("ISS"), shareholder proposals calling for a majority voting standard in director elections were more numerous than any other type of proposal in 2005, 2006 and 2007 and it continued to be one of the most numerous in 2008.ⁿ⁷⁹ In the 2008 proxy season, ISS tracked 87 such proposals, the vast majority of which were submitted by the United Brotherhood of Carpenters and Joiners.ⁿ⁸⁰ Average stockholder support for majority voting standard proposals in 2006 was 48.5 percent, with 34 companies receiving more than 50 percent support.ⁿ⁸¹ Average support in 2007 was close to 50 percent, with 15 companies receiving more than 50 percent support. Notably, approximately 70 of the over 150 majority voting standard proposals submitted in 2007 were withdrawn by the proponents, primarily because the companies agreed to adopt a majority voting standard.ⁿ⁸² In 2008 average support remained close to 50 percent and the trend of company cooperation over the proposals continued as roughly half of the 90 proposals submitted were withdrawn by the proponents.ⁿ⁸³

Many companies initially addressed shareholder interest in a majority voting standard by adopting director resignation policies, under which a company retains plurality voting but states that a director who is elected by less than a majority of the votes cast must tender his or her resignation. Majority voting standard shareholder proposals have tended to be defeated at companies with director resignation policies, although these proposals have still received significant support.ⁿ⁸⁴ Many shareholders do not view director resignation policies as an adequate substitute for a true majority voting standard.

Beginning with Intel Corporation in January 2006, many companies have adopted a true majority voting standard for uncontested director elections. Most companies have effected this change through bylaw amendments, although some have had to amend their certificates of incorporation (typically to address non-Delaware state law considerations). To address "holdover" directors (*i.e.*, incumbents who were not re-elected by a majority vote), most companies have also adopted a provision, either in their bylaws or as a separate corporate governance policy, requiring any holdover director to tender his or her resignation.ⁿ⁸⁵

By February 2007, over 52 percent of companies in the S&P 500 and over 45 percent of companies in the Fortune 500 had adopted either a director resignation policy or a majority voting standard, compared to just 16 percent of the S&P 500 in March 2006.ⁿ⁸⁶ Although most early adopters favored director resignation policies, the trend since September 2006 has been to adopt true majority voting standards.ⁿ⁸⁷ In addition, New York Senator Schumer's Stockholder Bill of Rights, Congressman Gary Peters' Shareholder Empowerment Act and Senator Dodd's discussion draft of the Restoring American Financial Stability Act of 2009 all include a requirement that the annual election of directors be conducted by majority rather than plurality voting.ⁿ⁸⁸

Importantly, in July 2009 the SEC approved proposed changes to New York Stock Exchange (NYSE) Rule 452 which eliminates discretionary voting by brokers in director elections.ⁿ⁸⁹ Previously, uncontested director elections were considered "routine," meaning that brokers could vote these undirected shares for a company's director nominees. Under amended NYSE Rule 452, however, brokers are no longer permitted to exercise discretionary voting authority in director elections. As a result, brokers are only permitted to vote in director elections if they received express voting instructions from their customers. Particularly for smaller companies or those with significant retail ownership, this could significantly decrease the number of shares voting.

[2] Reviewing the Structure, Composition and Functioning of the Board and Its Committees

[a] Board Independence

As discussed above,ⁿ⁹⁰ both the NYSE and NASDAQ require that listed company boards have a majority of independent directors, and many commentators have recommended that public company boards be composed of a "substantial majority" of independent directors.ⁿ⁹¹ In addition, both the NYSE and NASDAQ require listed companies to disclose the board's independence determinations in their annual proxy statements.ⁿ⁹² Finally, the NYSE requires that an officer of each listed company affirm on an annual basis (on behalf of the company) the company's compliance with NYSE independence requirements.ⁿ⁹³

[b] Recommending Candidates for Board Committees

The nominating/corporate governance committee often is responsible for making recommendations concerning the membership and responsibilities of the board's committees.ⁿ⁹⁴ The nominating/corporate governance committee also may be charged with selecting candidates to serve as committee chairs, if this is not done by the committees themselves. In performing this function, the nominating/corporate governance committee may consider periodic rotation of committee chairs and committee memberships among the directors, in order to provide a fresh perspective and to increase directors' understanding of additional areas of the company's business.ⁿ⁹⁵ In some companies, the board chair or lead independent director also may play a role in determining committee assignments and chairs.

When making recommendations concerning committee membership and responsibilities, the nominating/corporate governance committee should review relevant SEC rules and NYSE or NASDAQ listing standards relating to board committees. For example, Section 407 of the Sarbanes-Oxley Act of 2002 and related SEC rules require that each public company board of directors determine, and disclose in the company's annual report or proxy statement, whether the audit committee has at least one "audit committee financial expert" and, if so, name that person and state whether he or she is independent.ⁿ⁹⁶ Moreover, a NYSE-listed company's audit committee must consist of at least three independent

directors, each of whom must be "financially literate" as interpreted by the board in its business judgment.ⁿ⁹⁷ At least one member of a NYSE-listed company's audit committee must have accounting or related financial management expertise.ⁿ⁹⁸ Also, the NYSE's corporate governance listing standards require listed companies to have entirely independent audit, compensation and nominating/corporate governance committees, with written charters detailing each committee's purpose and responsibilities.ⁿ⁹⁹

NASDAQ requires each listed company to have an audit committee comprised of at least three independent directors, each of whom must be able to read and understand fundamental financial statements, including the company's balance sheet, income statement, and cash flow statement.ⁿ¹⁰⁰ At least one audit committee member must have past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background which results in that individual's financial sophistication.ⁿ¹⁰¹ Finally, the audit committee must have a written charter specifying certain committee responsibilities.ⁿ¹⁰² NASDAQ's corporate governance listing standards require that decisions relating to executive compensation and director nominations be made either by a majority of independent directors or by compensation and nominating committees composed solely of independent directors.

In addition to SEC, NYSE and NASDAQ requirements for committee composition, the nominating/corporate governance committee should consider "best practices" put forward by investors,ⁿ¹⁰³ business groups,ⁿ¹⁰⁴ directors' associationsⁿ¹⁰⁵ and others. For example, it may not be appropriate for all members of the compensation committee to be former chief executive officers; a diversity of professional backgrounds is important to the effective functioning of that committee.ⁿ¹⁰⁶

When evaluating potential committee chairs, the nominating/corporate governance committee should consider each candidate's leadership abilities, expertise, availability, skill in conducting meetings and familiarity with governance processes, among other things.ⁿ¹⁰⁷

[c] Board Retirement and Tenure Policies

Another matter for the nominating/corporate governance committee to consider is whether to establish retirement and tenure policies for the board of directors.ⁿ¹⁰⁸ Examples of restrictions on director tenure include a mandatory retirement age, term limits, and a requirement that directors who change employment tender a board resignation, giving the nominating/corporate governance committee an opportunity to evaluate their continued service on the board.ⁿ¹⁰⁹

Restrictions on director tenure can provide fresh perspectives to the board and strengthen the board's actual and perceived independence. They also may increase the company's score with corporate governance ratings services and proxy voting advisors, although Institutional Shareholder Services ("ISS") no longer awards points in its corporate governance rating tool (the Corporate Governance Quotient, or CGQ) for having a retirement age or mandatory term limits for directors.ⁿ¹¹⁰ However, in the United Kingdom, some institutional investors consider directors as no longer being independent after more than nine years of service.ⁿ¹¹¹

Rigid limits on director tenure may have some negative consequences. For example, they could result in the premature retirement of experienced directors who can still contribute meaningfully to the board. In addition, independent directors, who often need substantial time to learn about the company and its business, could be removed from the board too soon after they have "gotten up to speed."ⁿ¹¹² Some have argued that restrictions on director tenure also could become an excuse for the board not to perform meaningful evaluations of individual directors.ⁿ¹¹³ Nonetheless, every board should consider how best to assure that the board is periodically enhanced with new directors with fresh perspectives.

Director retirement and tenure policies are discussed in more detail in Chapter 7 above.

[d] Other Directorships

Being a corporate director requires substantial time and attention, and serving on too many other boards may prevent a director from fulfilling his or her obligations to the company.ⁿ¹¹⁴ In this regard, the nominating/corporate governance committee should consider whether to adopt a policy governing directors' service on other boards.ⁿ¹¹⁵ Many companies require directors to notify the chair of the nominating/corporate governance committee before accepting a seat on the board of another company or, in some cases, on the board of a non-profit organization. Others have specific, numerical restrictions on the number of board positions a director may hold. Such policies may be addressed in a company's corporate governance guidelines.ⁿ¹¹⁶

The National Association of Corporate Directors recommended that boards consider the following "guidelines" for limiting the board service of different categories of director candidates:ⁿ¹¹⁷

- CEOs and other senior officers: no more than one or two public company directorships, in addition to membership on their own company's board;
- Other individuals with full-time positions: no more than three or four public company directorships, in addition to membership on their own organization's board; and
- Other individuals: no more than five or six public company directorships.

Moreover, ISS awards additional points under its Corporate Governance Quotient rating tool to companies that limit board service for non-CEO directors to four or five boards. ISS also recommends that investors withhold votes from or vote against directors who sit on more than six public company boards and CEOs who serve on more than two public company boards (in addition to their own company's board). Because many institutional investors follow ISS proxy voting guidelines, nominees who serve on more than the recommended number of boards can expect to receive a high number of "withhold" or "against" votes in director elections.

The nominating/corporate governance committee also should consider whether to adopt specific limits on directorships for members of certain board committees. In this regard, commentary to the NYSE corporate governance listing standards states that "if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve to three or less, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee," and the company must disclose that determination in its proxy statement.ⁿ¹¹⁸

Finally, the nominating/corporate governance committee should review and approve senior officers' service on other boards and consider any legal restrictions on such service.ⁿ¹¹⁹

[e] Board Processes

It is the nominating/corporate governance committee's responsibility to see that the board establishes procedures covering such matters as meeting attendance, conflicts of interest, executive sessions, board access to senior management, director resignation and director interaction with customers, the media and shareholders.ⁿ¹²⁰ With respect to executive sessions, the NYSE's corporate governance listing standards require the non-management directors of each listed company to meet in regularly scheduled executive sessions without management present.ⁿ¹²¹ Similarly, NASDAQ's corporate governance listing standards mandate regularly scheduled meetings at which only the independent directors are present.ⁿ¹²² Business Roundtable's Principles of Corporate Governance 2005 suggest that time for an executive session be placed on the agenda for every regularly scheduled board meeting.ⁿ¹²³

The nominating/corporate governance committee, often in consultation with the lead or presiding director, also is often best suited to examine board policies relating to meeting schedules, meeting agendas, and the presence and participation of management at board and committee meetings.ⁿ¹²⁴

In addition, the nominating/corporate governance committee typically is responsible for assessing "the reporting channels through which the board receives information, and the quality and timeliness of information received, so that the board obtains appropriately detailed information in a timely fashion."ⁿ¹²⁵ In this regard, directors may receive relevant information from a number of sources, including management, board committees, independent advisors, internal and external auditors, and analyst and media reports (both positive and negative) relating to the company, management, the industry and corporate governance issues. Directors should be provided with such information in advance, with adequate time before meetings to reflect on important issues and to request additional materials as necessary.ⁿ¹²⁶ (In cases involving an emergency or highly sensitive information, the company may not be able to provide information in advance.) The nominating/corporate governance committee should assess the board's information flow in connection with the annual evaluation of the board.

[f] Director Orientation and Training

The nominating/corporate governance committee may be responsible for overseeing new director orientation and coordinating director training and education programs on an ongoing basis.ⁿ¹²⁷ Directors must understand the company, its business and the industry in order to be most effective.ⁿ¹²⁸ Orientation programs should involve the provision of information relating to the company and director responsibilities generally and can include discussions with company personnel and visits to company facilities.ⁿ¹²⁹ The nominating/corporate governance committee may want to ask directors (perhaps as part of the board evaluation process) to identify appropriate training programs for the board or particular board committees.ⁿ¹³⁰

Among the materials that may be useful to directors are:

- (1) board policies and codes of conduct;
- (2) board and committee charters;
- (3) the company's mission statement;
- (4) resumes of fellow directors;
- (5) minutes of recent board and committee meetings;
- (6) recent financial statements and proxy materials; and
- (7) a calendar of standing board agenda items.ⁿ¹³¹

Directors also should receive copies of company press releases, all analyst reports about the company, and a fair sampling of press coverage (including any articles that are critical of the company or its management). Some companies now put these materials on private websites, which directors can access with a password. These materials should be kept updated and directors regularly "refreshed" about the company's changing environment and circumstances.ⁿ¹³² Finally, all outside directors should be given the opportunity to visit the company's major facilities and meet with senior management and the company's auditors, counsel, lenders and major investors.ⁿ¹³³

In recent years, business schools, law schools, the national securities markets and private organizations have made efforts to establish training and education programs for corporate directors. Former SEC Chairman William H.

Donaldson stated in 2003 that the SEC would "help in any way possible" to accelerate those efforts.ⁿ¹³⁴ Institutional Shareholder Services ("ISS") maintains a list of "accredited" director education programs and awards Corporate Governance Quotient points to companies whose directors attend these programs.ⁿ¹³⁵

[g] Director Compensation

If the board's compensation committee does not do so, the nominating/corporate governance committee often is responsible for reviewing the company's director compensation program. Director compensation is subject to comprehensive disclosure in company proxy materials and can have a significant impact on the company's ability to attract, motivate and retain qualified board members.ⁿ¹³⁶ The board committee charged with overseeing director compensation should consider, among other things:

- the form and amount of director compensation;
- whether to pay a retainer and/or per-meeting fees;ⁿ¹³⁷
- customary fees for directors in the company's industry and peer group;
- whether to pay additional fees to directors who serve on key committees, as committee chairs, or as the presiding or lead independent director;ⁿ¹³⁸
- whether the company has made any direct or indirect payments to directors for consulting or other services; and
- legal restrictions on compensation of directors, including a statutory prohibition on personal loans to directors and NYSE and NASDAQ listing standards governing payments to "independent" directors (including audit, compensation and nominating/corporate governance committee members).ⁿ¹³⁹

Director compensation generally should include a mix of cash and equity compensation. Including equity as part of directors' compensation may help to align the interests of directors with those of shareholders.ⁿ¹⁴⁰ According to the Business Roundtable, "a meaningful portion of a director's compensation should be in the form of long-term equity."ⁿ¹⁴¹

In addition, companies may want to consider establishing a requirement that, for as long as directors remain on the board, they acquire and hold a meaningful amount of company stock.ⁿ¹⁴² According to a Steven Hall & Partners study, nearly one-third (32 percent) of companies had stock ownership guidelines for their directors in 2006.ⁿ¹⁴³ Among Business Roundtable companies, the number was significantly higher--88 percent of Roundtable companies reported having director stock ownership guidelines or requirements in 2006.ⁿ¹⁴⁴ Requiring directors to retain company stock for the duration of their service on the board provides an incentive for directors to focus on long-term shareholder value.ⁿ¹⁴⁵

In recent years, some investors have argued that stock options may not align the interests of directors with those of shareholders because prior to exercising options, directors do not assume any of the risk associated with a decrease in the company's stock price. For this reason, many companies have supplemented or replaced stock option grants for directors and officers with grants of full-value shares, restricted stock and other forms of equity compensation.ⁿ¹⁴⁶ In fact, a Towers Perrin survey of Fortune 500 companies found that the majority of companies no longer include stock options as part of their director compensation programs.ⁿ¹⁴⁷

[h] Board and Committee Evaluations

Under the NYSE corporate governance listing standards, one of the nominating/corporate governance committee's responsibilities must be to "oversee the evaluation of the board and management."¹⁴⁸ In addition, the committee's charter must address "an annual performance evaluation of the committee."¹⁴⁹

Meaningful board evaluations require an assessment of the effectiveness and contributions of the full board, the board's committees and its individual directors.¹⁵⁰ In overseeing evaluations of the full board (and in developing a set of corporate governance principles for the company¹⁵¹), the nominating/corporate governance committee should consider the following seven "aspirational norms" of board practice identified by former Chief Justice E. Norman Veasey of the Delaware Supreme Court:

- Every board should have a "heavy majority of purely independent directors."
- The board "should be engaged in actual governance, and not merely act as advisors" to the CEO.
- Directors should "meet face-to-face frequently throughout the year and spend substantial time on their homework."
- Directors should "limit to a reasonable number the major boards on which they serve."
- "Independent directors should regularly evaluate the CEO and they should meet with each other alone in executive session on a regular basis. The board should have independent audit, compensation and nominating committees."
- "The board should establish and monitor reasonable law compliance programs."
- The board "should carefully review disclosure documents to ensure that all material information reasonably available is disclosed to the relevant audience."¹⁵²

Board evaluations also may include a review of the board's understanding and role with respect to development of the company's strategy; the board's access to relevant, complete and timely information; the candor of board discussions (both among directors and with management and the company's auditors); and the board's culture, including directors' willingness to work together for the benefit of the company and all of its shareholders.¹⁵³

To evaluate itself, the board (through the nominating/corporate governance committee) may find it useful to compose a description of its duties, goals and objectives, which already may exist in the form of the company's corporate governance principles, and then measure its performance against those objectives.¹⁵⁴ The evaluation may be facilitated by having directors fill out confidential surveys or questionnaires,¹⁵⁵ or by conducting more informal discussions between directors and the nominating/corporate governance committee chair. Some companies use outside parties (such as consultants or outside counsel) to facilitate the evaluation process, compile peer survey responses and provide input on board processes.

By way of example, General Electric Company's Nominating and Corporate Governance Committee Key Practices include a list of issues to be discussed annually with each director with respect to both the full board and each committee on which the director serves. Specifically, GE's process solicits ideas from directors regarding:

- the board's prioritization of issues;
- the quality of information and analysis presented to the board or committee and the effectiveness of board or committee discussions;

- the manner in which issues arising in the past year could have been handled better;
- subjects that the board or committee should discuss in the future; and
- any other matters of importance to board functioning.ⁿ¹⁵⁶

GE directors are asked to provide their comments to an independent corporate governance expert for collating and discussion with the presiding director and committee chairs. The responses are then organized and summarized for discussion at board and committee meetings.ⁿ¹⁵⁷

[3] Developing and Reviewing Corporate Governance Guidelines

The nominating/corporate governance committee should play a central part in shaping the company's corporate governance. In this regard, the NYSE's corporate governance listing standards provide that the nominating/corporate governance committee's responsibilities must include developing and recommending to the board a set of corporate governance guidelines applicable to the company.ⁿ¹⁵⁸ Although many companies already have such guidelines (and have had them for some time), the NYSE standards include a number of subjects that must be addressed in the corporate governance guidelines of NYSE-listed companies:ⁿ¹⁵⁹

- *Director qualification standards.* At a minimum, these standards should reflect the board's independence requirements. They also may address other qualification requirements, including restrictions on the number of other boards on which a director may serve and director tenure and retirement policies.
- *Director responsibilities.* According to the NYSE, these responsibilities should articulate clearly what is expected from directors, including meeting attendance and preparation.
- *Director access to management and, as necessary and appropriate, independent advisors.*
- *Director compensation.* Commentary to the NYSE standards states that director compensation guidelines should include "general principles for determining the form and amount of director compensation," and that the board "should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary."ⁿ¹⁶⁰ Similar concerns may be raised when the company makes substantial charitable contributions to organizations affiliated with a director or enters into consulting or other compensation arrangements with a director. As discussed above, more and more companies are adopting director stock ownership guidelines and including mention of them in their corporate governance guidelines.ⁿ¹⁶¹
- *Director orientation and continuing education.*
- *Management succession.* According to the NYSE, succession planning should include "policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO."ⁿ¹⁶²
- *Annual performance evaluation of the board.* Finally, a NYSE listed company's board should conduct a self-evaluation "at least annually to determine whether it and its committees are functioning effectively."ⁿ¹⁶³

Other topics commonly addressed in corporate governance guidelines include board leadership (e.g., whether the CEO and board chair will be separated or combined in a single person, and whether the board has appointed a presiding or

lead independent director), the structure and function of the board's committees, the board's responsibility with respect to strategic planning and the nomination and election of directors,ⁿ¹⁶⁴ and the board's processes for handling communications with shareholders.

Under the NYSE standards, every listed company's website must include its corporate governance guidelines and the charters of its "most important committees," including the audit, compensation and nominating committees.ⁿ¹⁶⁵ Moreover, the listed company's annual proxy statement must state that the required information is available on the company's website and in print to any shareholder who requests it.

For companies not listed on the NYSE, there is no requirement that the nominating/corporate governance committee recommend, and the company adopt, a set of corporate governance guidelines. Nevertheless, many companies have chosen to do so as a matter of good corporate governance.ⁿ¹⁶⁶ Corporate governance rating services consider whether a company has adopted and disclosed corporate governance guidelines, and posting such guidelines on company websites may bolster investor confidence by providing easy access to information regarding corporate governance.

The current practices of the board and its committees may provide the best starting point for developing a set of corporate governance guidelines. In this regard, a company's corporate governance guidelines should reflect its current practices to the extent possible, except when the board recognizes a need to change them.ⁿ¹⁶⁷ Although each company's corporate governance guidelines should take into account its particular circumstances, the nominating/corporate governance committee should benchmark the board's practices against emerging corporate governance trends and best practices. This benchmarking process should include a review of board size, composition and duties; committee structure and membership; director compensation; director retirement and tenure policies; and corporate governance guidelines.ⁿ¹⁶⁸ Using this data, the nominating/corporate governance committee should recommend modifications to the corporate governance guidelines as appropriate.

[4] Reviewing the Company's Succession Plans

Succession planning generally is viewed as "one of the most important aspects of ensuring the future success of any corporation," and planning for the selection of future CEOs and senior managers is a primary function of corporate boards.ⁿ¹⁶⁹ This has been shown particularly true in recent years, as CEO tenures have declined. An IRRC study published in 2005 found that nearly 14 percent of companies had replaced their CEO since 2002ⁿ¹⁷⁰ and another 2005 report noted that two out of five CEOs were failing in their first 18 months on the job.ⁿ¹⁷¹ Despite these warning signs, the National Association of Corporate Directors ("NACD") has reported that almost half of companies with revenue greater than \$500 million have no meaningful CEO succession plan.ⁿ¹⁷² The nominating/corporate governance committee frequently is responsible for working with the CEO to develop and recommend to the board a succession plan to be used at the time of the CEO's retirement or departure.ⁿ¹⁷³ The committee also may be charged with reviewing other changes in the senior management team, although the CEO "should be given considerable discretion in selecting and retaining members of the management team."ⁿ¹⁷⁴

There are two kinds of succession planning:

- (1) Long-term planning for the retirement or departure of the CEO may include comparing potential internal candidates against a list of qualities and characteristics identified by the board as essential (or desirable) for an effective CEOⁿ¹⁷⁵ and performing periodic evaluations of the CEO and senior management, if this is not done by another board committee.ⁿ¹⁷⁶ It also may include becoming familiar with potential outside successors, if necessary.ⁿ¹⁷⁷
- (2) Contingency (or crisis) planning is equally critical and involves reviewing or developing emergency succession plans to deal with the unexpected death, incapacity or departure of the CEO or other senior executives.ⁿ¹⁷⁸

Generally, the nominating/corporate governance committee should keep in mind the following key succession planning principles, as outlined by the NACD's Blue Ribbon Commission on CEO Succession:ⁿ¹⁷⁹

- *The goal of CEO succession is finding the right leader at the right time.* The board should be ready with an understanding of the company's current and future needs and a pool of familiar candidates.ⁿ¹⁸⁰
- *CEO succession is a board-driven, collaborative process.* Although the CEO should be involved in identifying and evaluating potential successors, the board should drive the process.
- *CEO succession is a continuous process.* The board should regularly (as part of its "ordinary course" activities) review the company's succession plans and the development of potential successors.ⁿ¹⁸¹
- *The board should ensure that the CEO builds a talent-rich organization by attracting and developing the right people.* Promising candidates should be identified and tested early in their careers, and directors should create opportunities to meet and personally evaluate the company's rising stars.ⁿ¹⁸²
- *Succession planning should be driven by corporate strategy.* Identifying specific, essential CEO characteristics in advance--rather than in the heat of the moment--is the "best defense against being seduced by a candidate's reputation or personal qualities" when a critical skill is absent.ⁿ¹⁸³

[5] Shared Functions

[a] Management Evaluations

Both the nominating/corporate governance committee and the compensation committee (in addition to the independent directors as a group) may have a role to play in evaluating the performance of the CEO and senior management. Under the NYSE's corporate governance listing standards, for example, the compensation committee is responsible for reviewing and approving corporate goals and objectives relevant to CEO compensation and evaluating the CEO's performance in light of those goals, although the board may allocate the responsibilities of the compensation committee to another committee composed entirely of independent directors.ⁿ¹⁸⁴ Under the NYSE standards, the nominating/corporate governance committee is charged with overseeing the evaluation of management.ⁿ¹⁸⁵

Regardless of which committee is primarily responsible for conducting management evaluations, the CEO's performance should be reviewed on an annual basis, and the non-management directors should participate with the CEO in the evaluation of senior management.ⁿ¹⁸⁶ Moreover, the results of any CEO evaluation should be communicated privately to the CEO by representatives of the non-management directors.ⁿ¹⁸⁷ When evaluating the CEO, the relevant committee(s) should consider the following factors:

- the company's progress toward, or satisfaction of, its strategic objectives during the CEO's tenure;
- the CEO's judgment and integrity;
- the match between the CEO's skills and expertise and the company's current and future needs;
- the CEO's leadership abilities, including his or her relationship with senior management and other employees; and
- the quality of the CEO's relationships with board members, including his or her candor and willingness to answer questions and provide additional information upon request.ⁿ¹⁸⁸

[b] Legal Compliance

Another area in which the nominating/corporate governance committee may share responsibility with other board committees is legal compliance.ⁿ¹⁸⁹ Under the NYSE's corporate governance listing standards, one purpose of the audit committee must be to "assist board oversight" of the company's compliance with legal and regulatory requirements.ⁿ¹⁹⁰ Nevertheless, some companies vest oversight responsibility for legal compliance--or at least non-financial legal compliance--in their nominating/corporate governance committees, recognizing that audit committees have become increasingly burdened by SEC and securities market regulations. For such companies, the audit committee may play a supplemental role in monitoring legal compliance issues.

The directors charged with overseeing legal compliance should ensure that a process is in place to encourage appropriate attention to legal compliance issues (including compliance with contractual obligations) and claims against the corporation, and the timely reporting of significant legal matters to the board or an appropriate board committee.ⁿ¹⁹¹ Directors also should monitor the development and operation of compliance programs governing insider trading, disclosure and communications with shareholders and should meet with the company's general counsel as appropriate to discuss compliance issues.ⁿ¹⁹²

The committee (or committees) overseeing legal compliance also may be responsible for developing and monitoring compliance with a corporate code of conduct.ⁿ¹⁹³ Both the NYSE and NASDAQ require listed companies to adopt and make publicly available a code of conduct applicable to all directors, officers and employees, and both require that any waivers of the code for directors or executive officers be approved by the board or a board committee.ⁿ¹⁹⁴ In addition, SEC rules adopted pursuant to Section 406 of the Sarbanes-Oxley Act require public companies to disclose whether they have adopted a qualifying "code of ethics" covering the CEO and senior financial officers, make that code available to the public, and disclose any amendments to or waivers of specified code provisions relating to the CEO and senior financial officers.ⁿ¹⁹⁵

[c] Risk Assessment and Risk Management

The nominating/corporate governance committee may share responsibility for overseeing the company's policies relating to risk assessment and risk management.ⁿ¹⁹⁶ Although the NYSE's corporate governance listing standards require the audit committee to discuss the company's risk assessment and risk management policies, commentary to the NYSE standards indicates that the audit committee "is not required to be the sole body responsible for risk assessment and management."ⁿ¹⁹⁷ In fact, some boards oversee risk assessment and management through other mechanisms, including the nominating/corporate governance committee. According to the NYSE, these companies' processes "should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee."ⁿ¹⁹⁸ In light of the recent financial crisis, additional focus is being placed on the role of the board of directors with respect to the oversight of risk assessment and risk management. In this regard, in September 2009, the SEC proposed new rules to require enhanced disclosure about the board's role in the company's risk-management process and the effects, if any, that this role has on the company's board leadership structure.ⁿ¹⁹⁹ Accordingly, the topic of risk assessment and management and the appropriate board structure to oversee this area has become increasingly important for the board of directors.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretionBusiness & Corporate LawCorporationsDirectors & OfficersTerms in OfficeGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewBusiness & Corporate LawCorporationsShareholdersMeetings & VotingVoting SharesDirector Elections & RemovalsSecurities LawSelf-Regulating EntitiesNational Association of Securities

Dealers Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. See The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 23 (2003) available at <http://www.conference-board.org/publications/describe.cfm?id=823>.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.04(b)(i). Under the NYSE standards, the nominating/corporate governance committee's purpose and responsibilities must be addressed in a written charter. The NASDAQ standards require companies to certify that they have adopted a formal written charter or board resolution addressing the nominations process and "such related matters as may be required under the federal securities laws." NASDAQ Rule 5605(e).

(n3)Footnote 3. See Schedule 14A Item 7, 17 CFR § 240.14a-101; Regulation S-K Item 407, 17 CFR § 229.407.

(n4)Footnote 4. See Schedule 14A Item 7, 17 CFR § 240.14a-101; Regulation S-K Item 407, 17 CFR § 229.407.

(n5)Footnote 5. If the charter is not available on the company's website, the company must include a copy of the charter as an appendix to its proxy statement at least once every three years. A sample nominating/corporate governance committee charter is reproduced in Appendix 8-A to this chapter.

(n6)Footnote 6. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Address to the Council of Institutional Investors (Apr. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.

(N7)Footnote 7. See Proxy Disclosure and Solicitation Enhancements, SEC Release No. 33-9052 (July 10, 2009).

(n8)Footnote 8. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings--March 2006, at www.businessroundtable.org.

(n9)Footnote 9. ABA Corporate Director's Guidebook 82.

(n10)Footnote 10. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 450 (Feb. 2004); Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board: Designing Corporate Boards for a Complex World* 117 (Harv. Bus. Sch. Press 2004) [hereinafter Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* (2004)].

(n11)Footnote 11. See Chapter 9 below for a discussion of qualification requirements for audit committee members.

(n12)Footnote 12. See ABA Corporate Director's Guidebook 83; The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 31 (2003); Richard F. Kotz, *The Modern Nominating Committee*, 6 *Corp. Governance Advisor* 4, 4 (1998).

(n13)Footnote 13. See, e.g., Press Release, Calvert Group Ltd., Calvert Proposes Diversity Language for Corporate Governance and Nominating Committees (May 6, 2003) (on file with author).

(n14)Footnote 14. See Institutional Shareholder Services, 2008 Background Report: The Election of Directors, Board Independence and Related Issues 27-28 (2008).

(n15)Footnote 15. See Business Roundtable, Principles of Corporate Governance 2005 7, 13 (Nov. 2005); Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 119 (2004); The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 31 (2003); National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness 9 (2001). See also Russ Banham, *Finding the Right Board Mix Harder Than It Sounds*, Bowne Securities Connect (June 2005), excerpted from

Boards That Can Shoot Straight (2005), stating that "diversification is the key to a board's success" and that the "right mix of business, financial, operating, marketing, and other skills will put the board on the track to success."

(n16)Footnote 16. See Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 119 (2004).

(n17)Footnote 17. See Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 120-121 (2004).

(n18)Footnote 18. Dan Fitzpatrick & Damian Paletta, *BofA Urged by Regulators to Revamp Board of Directors*, *Wall St. J.*, May 15, 2009.

(n19)Footnote 19. See NYSE Listed Company Manual § 303A.01; NASDAQ Rule 5605(b).

(n20)Footnote 20. See, e.g., ABA Corporate Director's Guidebook 83; National Association of Corporate Directors, *The Governance Committee* 6 (2003); Business Roundtable, *Principles of Corporate Governance* 2005, 14 (Nov. 2005).

(n21)Footnote 21. See Business Roundtable, *Business Roundtable Corporate Governance Survey Trends--December 2008*, at www.businessroundtable.org.

(n22)Footnote 22. See Institutional Shareholder Services, *2008 Background Report: The Election of Directors, Board Independence and Related Issues* 5 (2008).

(n23)Footnote 23. See discussion in § 8.02 above.

(n24)Footnote 24. See Business Roundtable, *Principles of Corporate Governance* 2005, 14-15 (Nov. 2005), stating that when considering director independence, "the board should consider not only whether the director has any of the relationships covered by the board's independence standards but also whether the director has any other relationships, either directly or indirectly, with the corporation, senior management or other board members that could affect the director's actual or perceived independence." See also ABA Corporate Director's Guidebook 83. In an October 2003 speech to the National Association of Corporate Directors, former SEC Commissioner Cynthia Glassman stated that in her view, "personal relationships with the CEO--living in the same community, kids at the same school, moving in the same social circle--are just as likely to undercut independence" as financial relationships with the company. Cynthia A. Glassman, *Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors* (Oct. 20, 2003). On the other hand, some commentators argue that personal relationships between directors and members of management can promote more honest dialogue and constructive criticism. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 446 (Feb. 2004). In March 2004, the Delaware Supreme Court affirmed the dismissal of a shareholder derivative action against Martha Stewart because, among other things, the shareholder failed to show that three outside directors of Martha Stewart Living Omnimedia lacked sufficient independence to consider whether to take up the shareholder's claims. See *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004). The Court rejected the shareholder's "'structural bias' argument, which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decision making." *Beam*, 845 A.2d at 1050-51. The Court noted that although personal friendship may be relevant in determining whether a director is independent, "friendship must be accompanied by substantially more in the nature of serious allegations that would lead to a reasonable doubt as to a director's independence" for purposes of assessing whether a presuit demand would be futile. *Beam*, 845 A.2d at 1052. See also *California Public Employees' Retirement System v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144, at *29 (Dec. 18, 2002) (stating that personal friendships, without more, are "insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment"). But see *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003), in which the Delaware Chancery Court concluded that personal ties among the outside directors on a special litigation committee and the directors and officers being investigated negated the committee's independence.

(n25)Footnote 25. See Regulation S-K Item 407(a)(3), 17 CFR § 229.407.

(n26)Footnote 26. See National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness 8 (2001).

(n27)Footnote 27. See Institutional Shareholder Services, ISS U.S. Corporate Governance Policy 2008 Updates (Nov. 19, 2007).

(n28)Footnote 28. See § 8.03[1][d][iii] below.

(n29)Footnote 29. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 445-47 (Feb. 2004).

(n30)Footnote 30. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 445-47 (Feb. 2004).

(n31)Footnote 31. See NYSE Listed Company Manual § 303A.04(b)(i).

(n32)Footnote 32. See § 8.03[1][a][i] above.

(n33)Footnote 33. See Schedule 14A Item 7, 17 *CFR* § 240.14a-101; Regulation S-K Item 407, 17 *CFR* § 229.407.

(n34)Footnote 34. See ABA Corporate Director's Guidebook 82; John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421 (Feb. 2004).

(n35)Footnote 35. See National Association of Corporate Directors, The Governance Committee 22 (2003). See also Russ Banham, *Finding the Right Board Mix Harder Than It Sounds*, Bowne Securities Connect (June 2005), excerpted from *Boards That Can Shoot Straight* (2005).

(n36)Footnote 36. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 448 (Feb. 2004).

(n37)Footnote 37. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 448 (Feb. 2004); Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 117 (2004) (noting that by the time some people "reach the age at which most directors join boards, they are accustomed to expressing their own opinions and too often expecting others to fall into line" and "aren't necessarily skilled at listening to and reaching agreement with 'equals'").

(n38)Footnote 38. See Russ Banham, *Finding the Right Board Mix Harder Than It Sounds*, Bowne Securities Connect (June 2005), excerpted from *Boards That Can Shoot Straight* (2005); Business Roundtable, *The Nominating Process and Corporate Governance Committees: Principles and Commentary* 9 (2004), reproduced as Appendix 8-B to this chapter; Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 114-116 (2004).

(n39)Footnote 39. See National Association of Corporate Directors, The Governance Committee 23 (2003).

(n40)Footnote 40. NYSE Listed Company Manual § 303A.04(b) Commentary.

(n41)Footnote 41. See NYSE Listed Company Manual § 303A.04(b) Commentary.

(n42)Footnote 42. See ABA Corporate Director's Guidebook 84-85; Business Roundtable, *Principles of Corporate Governance* 21 (Nov. 2005); R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 *Mercer L. Rev.* 829, 860 (2003).

(n43)Footnote 43. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 449 (Feb. 2004); Business Roundtable, *The Nominating Process and*

Corporate Governance Committees: Principles and Commentary 9 (2004). As discussed above, SEC rules require disclosure of whether a company's nominating committee will consider candidates recommended by shareholders.

(n44)Footnote 44. See Business Roundtable, Principles of Corporate Governance 2005, 29 (Nov. 2005); Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 115, 124-127 (2004).

(n45)Footnote 45. See ABA Corporate Director's Guidebook 84. See also Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, Harv. Bus. Rev. (photo. reprint R0209H at 6) (2002).

(n46)Footnote 46. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings--March 2006, at www.businessroundtable.org.

(n47)Footnote 47. See Business Roundtable, Business Roundtable Corporate Governance Survey Highlights--March 2004, at www.businessroundtable.org.

(n48)Footnote 48. Of the companies in the 2006 Business Roundtable survey that performed (or planned to perform) individual director evaluations, a growing number relied on peer reviews: 38 percent in 2005 and 48 percent in 2006. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings--March 2006, at www.businessroundtable.org.

(n49)Footnote 49. A sample board and board committee self-evaluation form is reproduced in Appendix 6-B above.

(n50)Footnote 50. See § 8.03[2][h] below, and also Chapter 7 above, for further discussion of board and committee self-evaluations.

(n51)Footnote 51. See Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 126 (2004).

(n52)Footnote 52. See National Association of Corporate Directors, The Governance Committee 16 (2003).

(n53)Footnote 53. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 *Bus. Law.* 421, 449 (Feb. 2004); Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary 9 (2004); Business Roundtable, Principles of Corporate Governance 2005, 21 (Nov. 2005); The American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 3A.04, comment (d) (1992).

(n54)Footnote 54. Some companies find it useful to spell out this distinction in their annual proxy statements. See, e.g., Pitney Bowes Notice of the 2005 Annual Meeting and Proxy Statement 13-14 (Mar. 24, 2005), available at www.pb.com.

(n55)Footnote 55. See § 8.03[1][a][i] above.

(n56)Footnote 56. See Schedule 14A Item 7, 17 *CFR* § 240.14a-101; Regulation S-K Item 407, 17 *CFR* § 229.407.

(n57)Footnote 57. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings--March 2006, at www.businessroundtable.org.

(n58)Footnote 58. See Security Holder Director Nominations, SEC Release No. 34-48626 (Oct. 14, 2003).

(n59)Footnote 59. SEC rules permit shareholders seeking minority board representation to fill out a partial or "short" slate of shareholder nominees with management nominees. These rules make it easier for shareholders to carry out an election contest when control of the company is not at stake. See 17 *CFR* § 240.14a-4(d) (2003). See also Securities and Exchange Commission Division of Corporation Finance, Staff Report: Review of the Proxy Process

Regarding the Nomination and Election of Directors 4 (2003).

(n60)Footnote 60. *See* Security Holder Director Nominations, SEC Release No. 34-48626 (Oct. 14, 2003).

(n61)Footnote 61. *462 F.3d 121 (2d Cir. 2006)* . *See also* Rachel McTague, *SEC Delays Public Consideration of Proxy Access Issue until December*, BNA, Inc. Securities Regulation & Law, Oct. 16, 2006.

(n62)Footnote 62. *See* Press Release, U.S. Securities and Exchange Commission, Commission Calendars Proposed Amendment to Rule 14a-8 Governing Director Nominations by Shareholders (Sept. 7, 2006), *at* www.sec.gov; Press Release, U.S. Securities and Exchange Commission, Commission Announces Schedule for Action Regarding Section 404 of the Sarbanes-Oxley Act of 2002, Foreign Private Issuer Deregistration, Internet Availability of Proxy Materials, and Securities Exchange Act Rule 14a-8 (Oct. 11, 2006), *at* www.sec.gov.

(n63)Footnote 63. *See* www.sec.gov/spotlight/proxyprocess.htm.

(n64)Footnote 64. *See* Shareholder Proposals, SEC Release No. 34-56160 (July 27, 2007); Shareholder Proposals Relating to the Election of Directors, SEC Release No. 34-56161 (July 27, 2007).

(n65)Footnote 65. A proxy access proposal would also need to comply with state law and a company's charter and bylaws.

(n66)Footnote 66. Shareholder Proposals Relating to the Election of Directors, Release No. 34-56161 (July 27, 2007)

(n67)Footnote 67. *See* Synopsis, House Bill No. 19 (Apr. 10, 2009), *available at* <http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19?Opendocument>.

(n68)Footnote 68. *See* Delaware General Corporation Law § 112 (2009).

(n69)Footnote 69. *See* Press Release, American Bar Association Section of Business Law, "Corporate Laws Committee Takes Steps to Provide for Shareholder Access to the Nomination Process" (Jun. 29, 2009).

(n70)Footnote 70. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Address to the Council of Institutional Investors (Apr. 6, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.

(n71)Footnote 71. Luis A. Aguilar, Commissioner, U.S. Sec. & Exch. Comm'n, Increasing Accountability and Transparency to Investors, Remarks at the SEC Speaks in 2009 (Feb. 6, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch020609laa.htm>.

(n72)Footnote 72. Elisse B. Walter, Commissioner, U.S. Sec. & Exch. Comm'n, Restoring Investor Trust through Corporate Governance, Remarks before the Practicing Law Institute (Feb. 18, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch021809ebw.htm>.

(n73)Footnote 73. *See* Facilitating Shareholder Director Nominations, SEC Release No. 33-9046 (June 10, 2009).

(n74)Footnote 74. Elisse Walter, Commissioner, U.S. Sec. & Exch. Comm'n, SEC Rulemaking-Advancing the Law to Protect Investors, Remarks at 48th Annual Corporate Counsel Institute (Oct. 2, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch100209ebw.htm>.

(n75)Footnote 75. Shareholder Bill of Rights Act of 2009 S. 1074, 111th Cong. § 4 (2009); Shareholder Empowerment Act of 2009 H.R. 2861, 111th Cong. § 2 (2009).

(n76)Footnote 76. Investor Protection Act of 2009 H.R. 3817, 111th Cong. (2009).

(n77)Footnote 77. *Available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

(n78)Footnote 78. Former Delaware Supreme Court Chief Justice E. Norman Veasey, Joseph A. Grundfest and Ira M. Millstein each advocated a move to some form of majority voting in the March 10, 2004 public roundtable on the proposed shareholder access rules. Among the suggestions advanced by these commentators were an "advice and consent" model (creating disincentives for directors to serve against the will of the majority of shareholders), encouraging states to provide for majority voting in director elections, and exempting from the SEC's shareholder access rules (if adopted) issuers that provide for majority voting in director elections.

(n79)Footnote 79. *See* Investor Responsibility Research Center, 2007 Background Report: The Election of Directors, Board Independence and Related Issues 5 (2007); Investor Responsibility Research Center, The Election of Directors, Board Independence and Related Issues 4 (2005); Institutional Shareholder Services, The Election of Directors, Board Independence and Related Issues 4 (2006); RiskMetrics Group, 2008 Background Report: The Election of Directors, Board Independence and Related Issues 6 (2008).

(n80)Footnote 80. *See* RiskMetrics Group, 2008 Background Report: The Election of Directors, Board Independence and Related Issues 6 (2008).

(n81)Footnote 81. *See* Investor Responsibility Research Center, 2007 Background Report: The Election of Directors, Board Independence and Related Issues 5 (2007).

(n82)Footnote 82. RiskMetrics Group (ISS) 2007 Postseason Report: A Closer Look at Accountability and Engagement (October 2007), p. 17.

(n83)Footnote 83. RiskMetrics Group (ISS) 2008 Postseason Report: Weathering the Storm: Investors Respond to the Global Credit Crisis (October 2008), p. 23-24.

(n84)Footnote 84. *See* Claudia H. Allen, *Study of Majority Voting in Director Elections*, Feb. 5, 2007.

(n85)Footnote 85. There was initially some uncertainty under Delaware law as to whether a director could be forced to resign if he or she did not receive a majority vote. Recent amendments to the Delaware General Corporation Law, however, provide for the enforceability of advance contingent resignations, triggered only if a director is not elected by a majority vote and subject to the board's discretion as to whether to accept the resignation. *See* Delaware General Corporation Law § 141(b) (2006). The amendments also provide that a shareholder-adopted bylaw amendment that specifies a majority voting standard in director elections may not be further amended or repealed by the board. *See* Delaware General Corporation Law § 216 (2006). This change has led some companies to "get ahead" of shareholder-proposed bylaw amendments by adopting amendments at the board level--thus preserving the board's ability to alter or repeal the provisions if circumstances change. Other states have also amended their corporate laws to address majority voting. For example, California adopted legislation, effective January 1, 2007, that permits certain California-based companies to require that directors be elected by a majority of votes cast. *See California Corporations Code § 708.5* (2007). Ohio also amended its law, effective January 1, 2008, to permit the adoption of non-plurality voting standards in company articles of incorporation. *See Ohio Revised Code § 1701.55(B)* (2008). Washington took a broader approach, not only permitting the adoption of majority voting bylaws but also limiting terms for holdover directors, recognizing the enforceability of advance contingent resignations, and providing that majority voting bylaws adopted by shareholders are presumptively not subject to amendment by the board. *See Washington Revised Code §§ 23B.08.070, 23B.10.205* (2009).

(n86)Footnote 86. *See* Claudia H. Allen, *Study of Majority Voting in Director Elections*, Neal, Gerber & Eisenberg LLP Feb. 5, 2007.

(n87)Footnote 87. *See* Claudia H. Allen, *Study of Majority Voting in Director Elections*, Neal, Gerber & Eisenberg LLP Feb. 5, 2007.

(n88)Footnote 88. Shareholder Bill of Rights Act of 2009 S. 1074, 111th Cong. § 4 (2009); Shareholder Empowerment Act of 2009 H.R. 2861, 111th Cong. § 2 (2009).

(n89)Footnote 89. *See* Proposed Rule Change by New York Stock Exchange Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, File No. SR-2006-92, Amendment No. 4 (February 26, 2009).

(n90)Footnote 90. *See* § 8.03[1][a][ii] above.

(n91)Footnote 91. *See* NYSE Listed Company Manual § 303A.01; NASDAQ Rule 5605(b); ABA Corporate Director's Guidebook 83; National Association of Corporate Directors, The Governance Committee 6 (2003); Business Roundtable, Principles of Corporate Governance 2005, 14 (Nov. 2005).

(n92)Footnote 92. *See* NYSE Listed Company Manual § 303A.02(a); NASDAQ Rule 5606(b). The NYSE corporate governance listing standards provide that companies must identify not only which directors are independent but also the basis for that determination.

(n93)Footnote 93. *See* NYSE Section 303A.12(c). The NYSE also requires an interim written affirmation "promptly" after a change occurs in the composition of the board or any of the committees subject to Section 303A. The annual and interim written affirmations must be in the form specified by the NYSE.

(n94)Footnote 94. *See* Dan M. Mahoney & Scott Shuman, *The Corporate Governance Committee*, 11 Corp. Governance Advisor 5, 34 (2003); American Bar Association, Report of the American Bar Association Task Force on Corporate Responsibility 64-65 (2003); ABA Corporate Director's Guidebook 86; Business Roundtable, Principles of Corporate Governance 2005, 16, 22 (Nov. 2005).

(n95)Footnote 95. *See* ABA Corporate Director's Guidebook 86; Business Roundtable, Principles of Corporate Governance 2005, 16 (Nov. 2005).

(n96)Footnote 96. *See* 17 CFR § 229.407(d)(5). *See also* discussion in § 9.03[2][a] below.

(n97)Footnote 97. NYSE Listed Company Manual § 303A.07(a) Commentary.

(n98)Footnote 98. *See* NYSE Listed Company Manual § 303A.07(a) Commentary. According to the commentary, a person who satisfies the SEC's definition of an "audit committee financial expert" may be presumed to have accounting or related financial management expertise.

(n99)Footnote 99. *See* discussion in § 8.02 above and in Chapters 9 and 10 below.

(n100)Footnote 100. *See* NASDAQ Rule 5605(c)(2)(A).

(n101)Footnote 101. *See* NASDAQ Rule 5605(c)(2)(A). A director who qualifies as an "audit committee financial expert" under SEC rules is presumed to qualify as a financially sophisticated audit committee member under the NASDAQ standards. *See* Commentary to NASDAQ Rule 5605(c), IM-5605-4.

(n102)Footnote 102. *See* NASDAQ Rule 5605(c)(1).

(n103)Footnote 103. *See, e.g.*, Council of Institutional Investors, Corporate Governance Policies (2008); California Public Employees' Retirement System, Global Principles of Accountable Corporate Governance (2009).

(n104)Footnote 104. *See, e.g.*, Business Roundtable, Principles of Corporate Governance 2005 (Nov. 2005); The Conference Board, Corporate Governance Handbook 2007 (2007); Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary (2004).

(n105)Footnote 105. *See, e.g.*, National Association of Corporate Directors, The Governance Committee (2003).

(n106)Footnote 106. *See* Business Roundtable, Executive Compensation: Principles and Commentary 8 (Nov. 2003), reproduced in Appendix 15-A to Chapter 15 *below*.

(n107)Footnote 107. *See* National Association of Corporate Directors, The Governance Committee 12 (2003).

(n108)Footnote 108. *See* ABA Corporate Director's Guidebook 84.

(n109)Footnote 109. *See* Business Roundtable, Principles of Corporate Governance 2005, 29 (Nov. 2005). *See also* National Association of Corporate Directors, The Governance Committee 17 (2003). *But see* National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness 9 (2001) (suggesting that "decisions relating to a director's continuing effectiveness should be addressed on a case-by-case basis and not on the basis of an arbitrary age limit").

(n110)Footnote 110. ISS changed its position in June 2005 "because there is no research or evidence that the existence of director term limits or retirement ages improve performance or decrease risk." Institutional Shareholder Services, *Memo to CGQ-rated companies*, June 21, 2005.

(n111)Footnote 111. *See, e.g.*, The Financial Reporting Council, The Combined Code on Corporate Governance, 6 (June 2006).

(n112)Footnote 112. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 129 (2004).

(n113)Footnote 113. *See, e.g.*, Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 129 (2004).

(n114)Footnote 114. *See* Business Roundtable, Principles of Corporate Governance 2005, 25 (Nov. 2005); National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Director Professionalism 13-14 (2001 ed.). *See also* Richard F. Kotz, *The Modern Nominating Committee*, 6 Corp. Governance Advisor 4, 5 (1998) (asserting that "[b]ecause of the quantity of work necessary to be a thoughtful director determined to fulfill the fiduciary duty of board membership, it is not possible to serve on a large number of boards in addition to a full-time career").

(n115)Footnote 115. Some institutional investors (among them the California Public Employees' Retirement System) recommend that boards adopt and disclose guidelines addressing the competing time commitments faced by director candidates who serve on multiple boards. *See* California Public Employees' Retirement System, Global Principles of Accountable Corporate Governance § III.C.1 (2009).

(n116)Footnote 116. *See* NYSE Listed Company Manual § 303A.09 Commentary (a company's corporate governance guidelines may address policies limiting the number of boards on which a director may sit) and discussion in § 8.03[3] *below*.

(n117)Footnote 117. *See* National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Director Professionalism 14-15 (2001 ed.).

(n118)Footnote 118. NYSE Listed Company Manual § 303A.07(a) Commentary.

(n119)Footnote 119. For example, the Clayton Act prohibits simultaneous service as an officer or director of competing companies under certain conditions. *See* 15 U.S.C. § 19(a)(1) (2007).

(n120)Footnote 120. *See* National Association of Corporate Directors, The Governance Committee 6 (2003). *See also* Dan M. Mahoney & Scott Shuman, *The Corporate Governance Committee*, 11 Corp. Governance Advisor 5, 34 (2003) and the discussion of board processes in Chapter 7.

(n121)Footnote 121. See NYSE Listed Company Manual § 303A.03. The NYSE commentary defines "non-management directors" as all those who are not company executive officers, including directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason. If this group includes directors who are not "independent" under the NYSE Standards, then the listed company should at least once a year schedule an executive session including only independent directors. See NYSE Listed Company Manual § 303A.03 Commentary.

(n122)Footnote 122. See NASDAQ Rule 5606(b)(2).

(n123)Footnote 123. See Business Roundtable, Principles of Corporate Governance 2005, 26 (Nov. 2005).

(n124)Footnote 124. See ABA Corporate Director's Guidebook 88; National Association of Corporate Directors, The Governance Committee 31-32 (2003).

(n125)Footnote 125. Business Roundtable, Principles of Corporate Governance 22 (May 2002). See also Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, Harv. Bus. Rev. (photo. reprint R0209H at 5) (2002). The corporate secretary's role in facilitating a smooth flow of information between the board, management, shareholders and regulatory agencies is discussed in Chapter 14 below.

(n126)Footnote 126. Business Roundtable, Principles of Corporate Governance 2005, 27 (Nov. 2005). See also National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness 19-22 (2001).

(n127)Footnote 127. See Dan M. Mahoney & Scott Shuman, *The Corporate Governance Committee*, 11 Corp. Governance Advisor 5, 33 (2003).

(n128)Footnote 128. See John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 Bu. Law. 421, 450 (Feb. 2004); Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 130-132 (2004).

(n129)Footnote 129. For example, General Electric Company requires all non-employee directors to make two visits to GE businesses each year. Similarly, The Home Depot, Inc. recommends that each director visit a minimum of 12 stores annually. See <http://www.ge.com/en/citizenship/governance/govprinc.htm>.

(n130)Footnote 130. Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 131 (2004).

(n131)Footnote 131. See National Association of Corporate Directors, The Governance Committee 8-9 (2003).

(n132)Footnote 132. See Colin B. Carter & Jay W. Lorsch, *Back to the Drawing Board* 115, 130 (2004).

(n133)Footnote 133. See National Association of Corporate Directors, The Governance Committee 8 (2003). As noted above, General Electric mandates that directors visit facilities on a regular basis.

(n134)Footnote 134. William H. Donaldson, Remarks at the 2003 Washington Economic Policy Conference (Mar. 24, 2003).

(n135)Footnote 135. The list of ISS-accredited programs is available at <http://www.isscgq.com/CGQratings.htm>.

(n136)Footnote 136. See Richard F. Kotz, *The Modern Nominating Committee*, 6 Corp. Governance Advisor 4, 5 (1998); ABA Corporate Director's Guidebook 89-90. Issues relating to director compensation are also discussed in § 6.02[5] above and generally in Chapters 15 and 16 below.

(n137)Footnote 137. A 2008 Towers Perrin survey of director compensation at Fortune 500 companies found that

in 2007, "the proportion of companies that pay flat retainers for board and committee service continues to rise, while the number of companies that pay meeting fees continues to decline." Newbury, et al., Towers Perrin Director Compensation Trends-Fortune 500-Fiscal Year 2008 (September 2008). Similarly, a 2006 Institutional Shareholder Services ("ISS") survey found that annual retainers were the most prevalent component of director pay among S&P Super 1,500 companies. See Subodh Mishra, *Director Pay Rises Another 14%*, ISS Governance Weekly (Apr. 2006), at <http://blog.riskmetrics.com>.

(n138)Footnote 138. This is an increasingly common practice, particularly for audit committee members, as these directors' responsibilities grow. Towers Perrin found that audit committee members "often" receive more for their service than members of other committees, and ISS found that audit, compensation and nominating committee chairs receive extra pay 80 percent, 73 percent and 59 percent of the time, respectively. Newbury, et al., Towers Perrin Director Compensation Trends-Fortune 500-Fiscal Year 2008 (September 2008); Subodh Mishra, *Director Pay Rises Another 14%*, ISS Governance Weekly (Apr. 2006), at <http://blog.riskmetrics.com>.

(n139)Footnote 139. See § 8.02 above and Chapters 9 and 10 below. Many of these considerations are included in the discussion of director compensation accompanying the NYSE's corporate governance listing standards. See NYSE Listed Company Manual § 303A.09 Commentary.

(n140)Footnote 140. See Business Roundtable, Principles of Corporate Governance 2005, 25 (Nov. 2005). See also National Association of Corporate Directors, The Governance Committee 35-38 (2003). When equity compensation is used, however, the committee should keep in mind that NYSE and NASDAQ listing standards require shareholder approval of equity compensation plans and arrangements. See Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Equity Compensation Plans, 1934 Act Release No. 34-48108 (June 30, 2003).

(n141)Footnote 141. Business Roundtable, Principles of Corporate Governance 2005, 25 (Nov. 2005).

(n142)Footnote 142. Business Roundtable, Principles of Corporate Governance 2005, 25 (Nov. 2005).

(n143)Footnote 143. See Steven Hall & Partners, Redesigned Pay for Redefined Responsibilities: Board Remuneration Study (2006).

(n144)Footnote 144. See Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings--March 2006, at www.businessroundtable.org.

(n145)Footnote 145. According to Towers Perrin, the most common form of a director stock ownership guideline is a requirement that directors hold stock with an aggregate market value equal to a designated multiple of compensation. See Newbury, et al., Towers Perrin Director Compensation Trends-Fortune 500-Fiscal Year 2008 (September 2008). For example, Martha Stewart Living Omnimedia's stock ownership guidelines provide that non-management directors are expected to own company shares with a value equal to five times their annual retainer. Of the companies with director stock ownership guidelines in the 2006 Steven Hall & Partners study, most (83 percent) defined the ownership requirement as a multiple of the annual retainer. Alternatively, some companies use a "retention ratio" requiring directors to retain a certain percentage of the net shares acquired through restricted stock vesting or option exercises for some period of time, often until board service ends.

(n146)Footnote 146. See, e.g., Kathryn Kranhold, *Sign of Times: GE Chief Immelt to Receive Stock--Not Options*, Wall St. J., Sept. 18, 2003, at B1; Michael P. Bruno, *Microsoft to Issue Restricted Stock, Not Options*, Institutional Shareholder Services Governance Matters (2003); ABA Corporate Director's Guidebook 74-75. See also § 15.03 below discussing alignment of executive compensation with shareholder interests and § 16.05[2][c] below discussing best practice recommendations regarding equity-based compensation.

(n147)Footnote 147. See Towers Perrin, Directors' Compensation Moves Higher (July 2005). Similarly, a 2006 Steven Hall & Partners study found that only half of companies studied awarded options to directors, as compared to 72

percent awarding full-value shares. *See* Steven Hall & Partners, *Redesigned Pay for Redefined Responsibilities: Board Remuneration Study* (2006). *See also* Newbury, et al., *Towers Perrin Director Compensation Trends-Fortune 500-Fiscal Year 2008* (September 2008).

(n148)Footnote 148. NYSE Listed Company Manual § 303A.04(b)(i). According to a 2004 Institutional Shareholder Services study, 96 percent of S&P 500 companies regularly review their board's performance. *See* Russ Banham, *Finding the Right Board Mix Harder Than It Sounds*, Bowne Securities Connect (June 2005), excerpted from *Boards That Can Shoot Straight* (2005).

(n149)Footnote 149. NYSE Listed Company Manual § 303A.04(b)(ii).

(n150)Footnote 150. *See* discussion in § 7.04 above; Business Roundtable, *Principles of Corporate Governance* 2005, 28 (Nov. 2005). Individual director evaluations are discussed in § 8.03[1][c] above.

(n151)Footnote 151. *See* § 8.03[3] below.

(n152)Footnote 152. E. Norman Veasey, *Economics and Investor Expectations in Corporate Law*, *The Metropolitan Corporate Counsel* 1 (April 1998).

(n153)Footnote 153. *See* Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, *Harv. Bus. Rev.* (photo. reprint R0209H at 7) (2002); National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness* 15-16 (2001).

(n154)Footnote 154. *See* National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness* 24-25 (2001).

(n155)Footnote 155. A sample board and board committee self-evaluation form is reproduced in Appendix 6-B to Chapter 6 above.

(n156)Footnote 156. General Electric Company, *Nominating and Corporate Governance Committee: Key Practices*, at http://www.ge.com/pdf/company/governance/board/ge_nominating_committee_key_practices.pdf.

(n157)Footnote 157. General Electric Company, *Nominating and Corporate Governance Committee: Key Practices*, at http://www.ge.com/pdf/company/governance/board/ge_nominating_committee_key_practices.pdf.

(n158)Footnote 158. *See* NYSE Listed Company Manual § 303A.04(b)(i).

(n159)Footnote 159. *See* NYSE Listed Company Manual § 303A.09 Commentary. *See also* the thorough discussion of corporate governance guidelines in Chapter 6 above.

(n160)Footnote 160. NYSE Listed Company Manual § 303A.09 Commentary. Director compensation is discussed in more detail in § 8.03[2][g] above.

(n161)Footnote 161. *See* § 8.03[2][g] above.

(n162)Footnote 162. NYSE Listed Company Manual § 303A.09 Commentary.

(n163)Footnote 163. NYSE Listed Company Manual § 303A.09 Commentary.

(n164)Footnote 164. *See* § 8.03[1][d][iii] above for a discussion of majority voting in director elections.

(n165)Footnote 165. NYSE Listed Company Manual § 303A.09 Commentary.

(n166)Footnote 166. *See* Business Roundtable, *Principles of Corporate Governance* 2005, 22-23 (Nov. 2005).

Business Roundtable recommends that a company's corporate governance guidelines be publicly available and address, at a minimum, board leadership, qualifications for directors, director responsibilities, the structure and functioning of board committees, board access to management and advisers, director compensation, director orientation and continuing education, board evaluations and management succession.

(n167)Footnote 167. See Terry Gallagher, *Development and Disclosure of Corporate Governance Guidelines*, 10 Corp. Governance Advisory 5, 23 (2002).

(n168)Footnote 168. Union Pacific Corporation, for example, provides for such a review in its nominating/corporate governance committee charter. See Union Pacific Corp., *Corporate Governance and Nominating Committee of the Board of Directors Charter*, at http://www.up.com/investors/governance/governance_comm.pdf.

(n169)Footnote 169. John F. Olson & Michael J. Halloran, *The Succession Challenge*, 5 Corp. Governance Advisory 3, 1 (1997); Ram Charan, *Who Will Be Your Next CEO?*, Wall St. J., Feb. 8, 2005, at B2; L. Edward Shaw, *Board Responsibility for CEO Succession Planning*, 19 Insights 5, 16-19 (May 2005). See also SEC Staff Legal Bulletin No. 14E (Oct. 27, 2009) stating that "that CEO succession planning raises a significant policy issue regarding the governance of the corporation," and accordingly, shareholder proposals relating to succession planning will no longer be excludable as ordinary business.

(n170)Footnote 170. See Investor Responsibility Research Center, *The Election of Directors, Board Independence and Related Issues* 19 (2005).

(n171)Footnote 171. See Ram Charan, *Who Will Be Your Next CEO?*, Wall St. J., Feb. 8, 2005, at B2.

(n172)Footnote 172. See Ram Charan, *Who Will Be Your Next CEO?*, Wall St. J., Feb. 8, 2005, at B2.

(n173)Footnote 173. See generally National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on CEO Succession (1998); John F. Olson, *Succeeding at Succession: The NACD Report*, 6 Corp. Governance Advisor 6, 1 (1998); John F. Olson & Michael J. Halloran, *The Succession Challenge*, 5 Corp. Governance Advisor 3, 1 (1997). See also the discussion of corporate governance guidelines relating to management succession and development in § 6.02[7] above and the discussion of succession planning and management development in Chapter 7 above.

(n174)Footnote 174. ABA Corporate Director's Guidebook 87.

(n175)Footnote 175. See Business Roundtable, *Principles of Corporate Governance 2005*, 27-28 (Nov. 2005). See also Richard F. Kotz, *The Modern Nominating Committee*, 6 Corp. Governance Advisor 4, 5 (1998).

(n176)Footnote 176. See § 8.03[5][a] below.

(n177)Footnote 177. See National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on CEO Succession 9, 14-15 (1998); John F. Olson & Michael J. Halloran, *The Succession Challenge*, 5 Corp. Governance Advisor 3, 4 (1997).

(n178)Footnote 178. See ABA Corporate Director's Guidebook 88; Business Roundtable, *Principles of Corporate Governance 2005*, 28 (Nov. 2005); L. Edward Shaw, *Board Responsibility for CEO Succession Planning*, 19 Insights 5, 16-19 (May 2005).

(n179)Footnote 179. See National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on CEO Succession 2 (1998).

(n180)Footnote 180. See Ram Charan, *Who Will Be Your Next CEO?*, Wall St. J., Feb. 8, 2005, at B2.

(n181)Footnote 181. L. Edward Shaw, *Board Responsibility for CEO Succession Planning*, 19 *Insights* 5, 17 (May 2005). "Ordinary course" activities in which succession planning may be grounded include: (1) understanding the company's business and objectives; (2) evaluating the performance of the CEO and other senior officers against clear benchmarks; (3) discussing performance evaluations (and reactions) with the CEO; and (4) using other activities (such as site or office visits) to observe and engage potential successors. *See* L. Edward Shaw, *Board Responsibility for CEO Succession Planning*, 19 *Insights* 5, 17 (May 2005). *See also* Ram Charan, *Who Will Be Your Next CEO?*, *Wall St. J.*, Feb. 8, 2005, at B2.

(n182)Footnote 182. *See* Ram Charan, *Who Will Be Your Next CEO?*, *Wall St. J.*, Feb. 8, 2005, at B2.

(n183)Footnote 183. Ram Charan, *Who Will Be Your Next CEO?*, *Wall St. J.*, Feb. 8, 2005, at B2. *See also* L. Edward Shaw, *Board Responsibility for CEO Succession Planning*, 19 *Insights* 5, 18 (May 2005) (suggesting that the board's definition of the competencies and personal characteristics of a CEO be as specific as possible and maintained on an "evergreen" basis).

(n184)Footnote 184. *See* NYSE Listed Company Manual § 303A.05(b)(i); NYSE Listed Company Manual § 303A.05 Commentary.

(n185)Footnote 185. *See* NYSE Listed Company Manual § 303A.04(b)(i).

(n186)Footnote 186. *See* Business Roundtable, *Principles of Corporate Governance* 2005, 28 (Nov. 2005). *See also* discussion of corporate governance guidelines regarding CEO evaluations in § 6.02[8][c] above.

(n187)Footnote 187. *See* Business Roundtable, *Principles of Corporate Governance* 2005, 28 (Nov. 2005).

(n188)Footnote 188. *See* National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on CEO Succession* 13 (1998). Evaluation of the CEO and senior management is discussed in more detail in Chapter 7 above.

(n189)Footnote 189. Compliance and company codes of conduct are discussed in more detail in Chapter 13 below.

(n190)Footnote 190. NYSE Listed Company Manual § 303A.07(c)(i)(A)(2). *See* § 9.04[2][h][i] below for discussion of the audit committee's role in compliance oversight and § 13.02 below for discussion of compliance generally.

(n191)Footnote 191. ABA Corporate Director's Guidebook 29. *See also* *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

(n192)Footnote 192. *See* Report of the American Bar Association Task Force on Corporate Responsibility 31-32 (Mar. 2003), 59 *Bus. Law* 145 (2003) (recommending that a company's general counsel have "primary responsibility for assuring the implementation of an effective legal compliance system under the oversight of the board of directors," and that the general counsel meet "regularly and in executive session" with a committee of independent directors to communicate concerns regarding legal compliance matters).

(n193)Footnote 193. *See* R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 *Mercer L. Rev.* 829, 863-864 (2003); Betsy Atkins, *Defining the Governance Committee Role*, 27 *Director's Monthly* 2, 11 (2003).

(n194)Footnote 194. *See* NYSE Listed Company Manual § 303A.10; NASDAQ Rule 5610. Corporate codes of conduct are discussed in detail in Chapter 13 below.

(n195)Footnote 195. 17 *CFR* § 229.406 (2005). Under SEC rules and NYSE listing standards, a company may post amendments and waivers of its code of ethics on its Internet website, provided that the company discloses its intent to

do so in its annual report on Form 10-K or proxy statement. Under NASDAQ listing standards, however, any waivers of the code for directors or executive officers must be disclosed on Form 8-K.

(n196)Footnote 196. The role of management, internal auditors and outside auditors in risk assessment and risk management is discussed in Chapter 14 *below*.

(n197)Footnote 197. NYSE Listed Company Manual § 303A.07(c)(iii)(D) Commentary. The audit committee's role in risk management is discussed in more detail in § 9.04[2][h][iii] *below*.

(n198)Footnote 198. NYSE Listed Company Manual § 303A.07(c)(iii)(D) Commentary. For more information on oversight of risk assessment and management policies, *see* National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Risk Oversight: Board Lessons for Turbulent Times (2002).

(n199)Footnote 199. *See* Proxy Disclosure and Solicitation Enhancements, SEC Release No. 33-9052 (July 10, 2009).



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Appendix 8-A: Sample Nominating/Corporate Governance Committee Charter

1-8-A Corporate Governance: Law and Practice Appendix 8-A:.syn

§ 8-A.syn Synopsis to Appendix 8-A: Sample Nominating/Corporate Governance Committee Charter

[8-A] Sample Nominating/Corporate Governance Committee Charter



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Appendix 8-A: Sample Nominating/Corporate Governance Committee Charter

1-8-A Corporate Governance: Law and Practice [8-A]

[8-A] Sample Nominating/Corporate Governance Committee Charter

The following nominating/corporate governance committee charter was developed for use by companies listed on the NYSE and incorporates the NYSE's corporate governance listing standards. It is comprehensive and is intended to include all duties and responsibilities that the NYSE listing standards and best practices dictate.

NOMINATING/CORPORATE GOVERNANCE COMMITTEE CHARTER

1. Members. The Board of Directors of _____ (the "Company") appoints a Nominating/Corporate Governance Committee of at least three members, consisting entirely of independent directors, and designates one member as chairperson or delegates the authority to designate a chairperson to the Nominating/Corporate Governance Committee. For purposes hereof, an "independent" director is a director who meets the New York Stock Exchange definition of "independence," as determined by the Board.
2. Purpose, Duties and Responsibilities. The purpose, duties and responsibilities of the Nominating/Corporate Governance Committee will be to identify individuals qualified to become Board members (consistent with criteria approved by the Board); recommend to the Board director candidates for election at the annual meeting of stockholders; develop and recommend to the Board a set of corporate governance principles; and perform a leadership role in shaping the Company's corporate governance. Among its specific duties and responsibilities, the Nominating/Corporate Governance Committee will:
 - (a) Develop and recommend to the Board criteria for identifying and evaluating director candidates.
 - (b) Identify, review the qualifications of, and recruit candidates for election to the Board.
 - (c) Assess the contributions and independence of incumbent directors in determining whether to recommend them for reelection to the Board.
 - (d) Establish a procedure for the consideration of Board candidates recommended by the Company's stockholders.
 - (e) Recommend to the Board candidates for election or reelection to the Board at each annual

stockholders' meeting.

- (f) Recommend to the Board candidates to be elected by the Board as necessary to fill vacancies and newly created directorships.
- (g) Develop and recommend to the Board a set of corporate governance principles and review and recommend changes to these principles as necessary.
- (h) Make recommendations to the Board concerning the structure, composition and functioning of the Board and its committees.
- (i) Recommend to the Board candidates for appointment to Board committees and consider periodically rotating directors among the committees.
- (j) Review and recommend to the Board retirement and other tenure policies for directors.
- (k) Review directorships in other public companies held by or offered to directors and senior officers of the Company.
- (l) Review and assess the channels through which the Board receives information, and the quality and timeliness of information received.
- (m) Review the compensation of directors for service on the Board and its committees and recommend changes in compensation to the Board. ***[May be done by the compensation committee, in whole or in part, at some companies.]***
- (n) Review the Company's succession plans relating to the CEO and other senior officers. ***[May be done by the compensation committee, in whole or in part, at some companies.]***
- (o) Oversee the evaluation of the Board and management. ***[Management evaluation may be done by the compensation committee, in whole or in part, at some companies.]***
- (p) Annually evaluate the performance of the Nominating/Corporate Governance Committee and the adequacy of the committee's charter.

3. Outside advisors. The Nominating/Corporate Governance Committee will have the authority to retain [at the expense of the Company] such outside counsel, experts, and other advisors as it determines appropriate to assist it in the full performance of its functions, including sole authority to retain and terminate any search firm used to identify director candidates, and to approve the search firm's fees and other retention terms.

4. Meetings. The Nominating/Corporate Governance Committee will meet as often as may be deemed necessary or appropriate in its judgment, either in person or telephonically, and at such times and places as the committee determines. The majority of the members of the Nominating/Corporate Governance Committee constitutes a quorum. The Nominating/Corporate Governance Committee will report regularly to the full Board with respect to its activities.



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Appendix 8-B Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004)

1-8-A Corporate Governance: Law and Practice Appendix 8-B.syn

§ 8-A.syn Synopsis to Appendix 8-A: Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004)

[8-B] Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004)



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Appendix 8-B Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004)

1-8-A Corporate Governance: Law and Practice [8-B]

[8-B] Business Roundtable, The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004) *

The Nominating Process and Corporate Governance Committees: Principles

1. The corporate governance committee, which should be composed entirely of independent directors, should play a leadership role in shaping a company's corporate governance and overseeing the composition, structure, operation and evaluation of the board and its committees.
2. The corporate governance committee should take responsibility for assuring that a substantial majority of the board meets appropriate standards of independence developed by the committee and approved by the board.
3. The corporate governance committee should develop and recommend to the board a set of corporate governance principles, which the corporation should make publicly available.
4. Director candidates should be identified, evaluated and recommended to the board by the corporate governance committee. The corporate governance committee should consider director candidates recommended by stockholders, as well as suggestions from directors, management and other sources.
5. The corporate governance committee should have an established process for evaluating the independence, contributions and effectiveness of incumbent directors when deciding whether to recommend those directors for re-nomination.
6. The corporate governance committee should be responsible for establishing and overseeing procedures for stockholder communications with directors if the full board or another committee does not do so.
7. The corporate governance committee should assist the board in planning for CEO and senior management development and succession if another committee of independent directors does not do so.

Introduction

Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in improving corporate governance practices. Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.7 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

Every publicly owned corporation should have an independent board committee that addresses director nominations and corporate governance issues. An effective corporate governance committee (often combined with, or referred to as, a nominating committee) is central to the functioning of the board. Traditionally, the corporate governance committee's role was to recommend director candidates to the board and the corporation's stockholders. Over the past decade, however, the committee's role has expanded so that today at many corporations it plays a leadership role in shaping corporate governance and overseeing the composition, structure, operation, compensation and evaluation of the board and its committees.

Business Roundtable has developed seven principles to serve as best practices for the nominating process and corporate governance committees. These principles are discussed in more detail in the commentary that follows. While the commentary illustrates ways to implement the principles, other approaches may be appropriate given the circumstances of an individual corporation.

It is critical to have independent director oversight of board nominations and operations. However, references in the principles and commentary to the corporate governance committee are not intended to preclude corporations from allocating responsibility for particular matters to a different committee, to the independent directors as a group or to the full board. (For example, although the principles suggest that the corporate governance committee should assist the board in planning for CEO and senior management succession, at some corporations the compensation committee is charged with this responsibility.) What is important is that key corporate governance issues are addressed effectively by the independent members of the board.

Commentary on Principles

1. The corporate governance committee, which should be composed entirely of independent directors, should play a leadership role in shaping a company's corporate governance and overseeing the composition, structure, operation and evaluation of the board and its committees.

- Members of the corporate governance committee should be independent in both fact and appearance, as determined by the board. They should have the ability to exercise independent judgment free from any relationship or influence that could compromise their ability to approach nominating and governance issues decisively and independently.
- The responsibilities of the corporate governance committee should be set out in a written committee charter that is made publicly available to stockholders and other interested parties.
- The committee's responsibilities should include identifying, evaluating and recommending director candidates to the board; establishing criteria for board and board committee membership; overseeing the evaluation of the board; developing and recommending to the board for public release a set of corporate governance principles; providing direction and oversight for director orientation and continuing education programs; overseeing procedures for stockholder communications with the board; and

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assisting the board and the CEO in planning for CEO and senior management development and succession (or seeing that another committee or the full board addresses these issues).

■ The corporate governance committee should review the board's committee structure and recommend candidates for membership on the board's committees. As the corporation's circumstances change, it may be appropriate for the committee to recommend that the board add or dissolve board committees (other than those required by law, regulation or listing standards).

In recommending committee membership, the corporate governance committee should focus on the strengths that different directors bring to the committees and the needs of the committees.

It is the corporate governance committee's responsibility to see that key board committees, including the audit, compensation and nominating-corporate governance committees, are composed of directors who meet applicable independence and qualification standards.

When evaluating potential committee chairs, the corporate governance committee should consider each candidate's leadership abilities, as well as his or her expertise and availability.

The corporate governance committee, along with the full board, should consider whether periodic rotation of committee membership and chairs would provide fresh perspectives and enhance directors' familiarity with different aspects of the corporation's business.

■ The corporate governance committee should be responsible for overseeing the effective functioning of the board. The committee should review the board's policies relating to meeting schedules, meeting agendas and the participation of management at board and committee meetings.

The committee should evaluate the quality and timeliness of information received by the board and the manner in which it is provided. The board should receive from management in a timely manner appropriately detailed information, and directors should request additional information as necessary.

The board also should be provided with information from sources outside the corporation, including analyst and press reports (both positive and negative) relating to the corporation, management, the industry and corporate governance issues.

The board should have an opportunity to meet with members of management on a regular basis in order to assess their capabilities and to stay apprised of issues facing the company and its industry.

■ The corporate governance committee should oversee evaluation of board and board committees performance and individual director contributions.

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The performance of the full board should be evaluated at least annually.

Companies conduct board evaluations in a variety of ways, including discussions led by the board chair or the chair of the corporate governance committee, annual board self-evaluation questionnaires and the use of third parties.

The committee and the board should assess how directors work as a group and with the CEO and whether changes in the composition of the board or key committees would better serve the corporation's interests.

Evaluation of the board involves a candid assessment of the board's strengths and weaknesses. The committee should report to the board on any weaknesses identified through the evaluation process and, together with the board, should develop and implement plans to address those weaknesses.

The corporate governance committee should conduct its own committee self-evaluation and should assist other board committees with their self-evaluations.

Individual directors' contributions should be evaluated in connection with the re-nomination process, as discussed below.

■ The corporate governance committee should establish procedures for the retirement or replacement of board members. Such procedures may include a mandatory retirement age or term limits. In addition, directors who change primary employment should notify the chair of the corporate governance committee so that the committee may determine whether the director's continued service on the board is appropriate.

■ The corporate governance committee should ask directors and the most senior executive officers to notify the corporate governance committee chair before accepting a position on another for-profit company's board.

■ The corporate governance committee, if the compensation committee does not do so, should review and recommend changes to the corporation's director compensation policies.

A meaningful portion of a director's compensation should be in the form of long-term equity.

The committee should consider establishing a requirement that, for as long as directors remain on the board, they hold a meaningful amount of company stock.

The committee should review the compensation provided to the lead or presiding director (if one has been designated) and key committee chairs to determine whether supplemental compensation, reflecting their additional responsibilities and time commitment, would be appropriate.

2. *The corporate governance committee should take responsibility for assuring that a substantial majority of the board meets appropriate standards of independence developed by the committee and approved by the board.*

- The corporate governance committee should monitor and safeguard the independence of the board and should see that a substantial majority of directors are independent in both fact and appearance, as determined by the board.
- The committee should develop and recommend to the board standards for determining directors' independence, taking into account the requirements of the federal securities laws and applicable securities markets and the views of institutional investors and other relevant groups.
- An independent director should not have relationships with the corporation or its management - whether business, employment, charitable or personal --that could impair his or her ability to exercise independent judgment.
- The committee should have a rigorous screening process to uncover any conflicts of interest or other relationships affecting independence. Director questionnaires are a useful part of this process. The committee also should review information from other sources as necessary.

3. *The corporate governance committee should develop and recommend to the board a set of corporate governance principles, which the corporation should make publicly available.*

- The corporate governance committee should develop, recommend to the board and update as necessary a set of corporate governance principles.
- The corporate governance principles of a public corporation should address, at a minimum, board leadership, qualifications for directors (including independence standards), director responsibilities, the structure and functioning of board committees, the board's access to management and independent advisers, director compensation, director orientation and continuing education, board evaluations, and management succession.
- The corporate governance principles should be made publicly available to the corporation's stockholders and other interested parties.
- The corporate governance committee should conduct regular reviews of corporate governance trends and best practices and should recommend changes to the principles and board practices as appropriate.

4. *Director candidates should be identified, evaluated and recommended to the board by the corporate governance committee. The corporate governance committee should consider director candidates recommended by stockholders, as well as suggestions from directors, management and other sources.*

- A core function of the corporate governance committee is selecting and recommending to the board qualified director candidates for election by the corporation's stockholders. To perform this responsibility properly, the committee should prepare and recommend to the board written criteria for director candidates. Over time, the committee should evaluate whether changes to the board's criteria are appropriate.

In developing criteria and evaluating individual candidates for nomination, the

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corporate governance committee should consider the background and expertise of existing board members and the specific needs of the board.

The composition of the board should reflect a mix of talents, experience, expertise and perspectives appropriate to the corporation's circumstances and strategic challenges, and the corporate governance committee should plan ahead for changes in board composition.

The committee should consider candidates from a range of backgrounds. Diversity in gender, age, race and perspective all are appropriate considerations. In recent years, corporations have drawn directors from a variety of sources, including the public sector, educational and charitable institutions, and senior management in addition to current and former CEOs.

Important criteria for directors include integrity, candor, good judgment, commitment and willingness to consider matters before the board with objectivity and impartiality. In addition, the committee should consider whether candidates have the requisite knowledge, skills and experience to understand the business of the corporation. A candidate's prior success as a manager or director of another corporation or significant enterprise also may be relevant.

The board's membership criteria should be disclosed to the corporation's stockholders and included in its corporate governance principles. As the board's needs change, the corporate governance committee should update its criteria for membership.

● Many corporate governance committees use executive search firms to assist them in identifying and recruiting qualified board candidates. Any such outside firm should be retained by, and report directly to, the corporate governance committee.

● The corporate governance committee should encourage stockholder suggestions regarding board composition and should consider director candidates recommended by stockholders.

The corporation should disclose publicly how and when stockholders may recommend director candidates to the corporate governance committee for consideration and should indicate the information that must be provided so that those candidates can be considered by the committee. The corporation should update this information as necessary.

The committee should evaluate stockholder candidates for director using the same criteria it uses to evaluate candidates recommended by other sources.

The committee should consider the candidate's ability to act in the best interests of the corporation and all of its stockholders.

The committee should communicate with any stockholder who recommends a

candidate to the committee, informing him or her of the receipt and status of the recommendation and the committee's determination regarding the candidate.

- Although it is appropriate for the CEO to meet with board candidates, final responsibility for selecting director nominees should rest with the corporate governance committee and the board.

5. *The corporate governance committee should have an established process for evaluating the independence, contributions and effectiveness of incumbent directors when deciding whether to recommend those directors for re-nomination.*

- Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board and act in the best interests of stockholders. The corporate governance committee should have a rigorous process for evaluating whether incumbent directors continue to have the appropriate skills and experience to contribute to the board.

In assessing a director's contributions, the following should be considered: his or her attendance, preparation and active participation at board and committee meetings; input from the CEO; the board's criteria for membership; and current needs for particular background and expertise.

The committee should evaluate a director's availability and commitment going forward.

- Corporate governance committees use a variety of means to assess directors' contributions, including discussions led by the board chair or the chair of the corporate governance committee, confidential self-evaluations or peer evaluations.

6. *The corporate governance committee should be responsible for establishing and overseeing procedures for stockholder communications with directors if the full board or another committee does not do so.*

- Every publicly owned corporation should have effective and meaningful procedures for stockholders to communicate with the board and for directors to respond to stockholder concerns.

Such procedures may include a mailing address, telephone number or electronic-mail address for stockholders to register concerns or questions with the board as a whole, the independent directors or key committee chairs.

The board, the corporate governance committee or members of management should consider meeting with stockholders regarding issues of concern.

The corporate governance committee, another committee or the full board should oversee the corporation's response to proposals submitted by stockholders. It may be appropriate for members of the board to meet with stockholders regarding specific proposals. In addition, the corporation should communicate its response to stockholder proposals that receive a majority vote.

- Directors should attend the corporation's annual meeting of stockholders and have a process for

responding to stockholder questions concerning the corporation. At the annual meeting, committee chairs may wish to make presentations on certain issues.

7. *The corporate governance committee should assist the board in planning for CEO and senior management development and succession if another committee of independent directors does not do so.*

■ Long-term planning for CEO and senior management development and succession is one of the board's most important functions. The corporate governance committee should assist the board in identifying and regularly updating the qualities necessary for an effective CEO of the corporation.

The board or the committee should monitor the development and progression of potential internal candidates using these standards.

The board or the committee should review with the CEO what is being done to prepare potential candidates for succession.

■ Emergency succession planning is equally critical. Working with the CEO, the board should assure that the corporation has a plan to deal with unexpected events, such as the sudden departure, death or disability of the CEO or other senior managers.

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CHAPTER 9 THE AUDIT COMMITTEE

1-9 Corporate Governance: Law and Practice 9.syn

AUTHOR: Bart Schwartz

§ 9.syn Synopsis to Chapter 9: THE AUDIT COMMITTEE

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[f] Receipt, Retention and Processing of Complaints

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[3] Other Audit Committee Best Practices Recommendations

[a] Initial Orientation and Continuing Education

[b] Audit Committee Agenda and Meetings

[c] Time Commitment and Audit Committee Compensation

Bart Schwartz n*

FOOTNOTES:

(n1)Footnote *. Scott M. Davies. Of Counsel at Gibson, Dunn & Crutcher LLP, assisted in the preparation of the 2009 supplement to this chapter.



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CHAPTER 9 THE AUDIT COMMITTEE

1-9 Corporate Governance: Law and Practice § 9.01

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§ 9.01 Importance of the Audit Committee

In responding to Enron and other corporate governance debacles of the new millennium, policymakers focused largely on the responsibilities of the independent directors, including, especially, the board audit committee. Under the rules already in effect, every company with shares listed on the New York Stock Exchange ("NYSE"), the NASDAQn1 or the American Stock Exchange ("Amex") (collectively, the "SROs" (self-regulatory organizations)) was required to have an audit committee comprised solely of independent directors (subject only to certain very limited exceptions) with a formal audit committee charter.n2

In the post-Enron reforms, lawmakers adopted a plethora of new rules governing and assigning responsibilities to public company audit committees:

- Several sections of the Sarbanes-Oxley Act of 2002n3 (the "Sarbanes-Oxley Act" or "Sarbanes-Oxley") bear directly or indirectly on the composition and functioning of public company audit committees;n4
- the Securities and Exchange Commission (the "SEC" or the "Commission") adopted rules relating to board audit committees of SEC registrants;n5 and
- the SROs proposed and the SEC approved new corporate governance listing standards dealing specifically with audit committee charters, composition, procedures, duties and responsibilities.n6

Due to the renewed and intensified focus on the board audit committee in the post-Enron era, that committee has become the workhorse of U.S. public companies. Policymakers have assigned to the audit committee a number of required tasks designed to promote not only the integrity and fairness of the company's public disclosure and reporting but also compliance with law and regulations generally. As a result, audit committee members are required to take on some of the most critical, extensive, and time-consuming responsibilities of all directors.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral
 OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretionBusiness &
 Corporate LawCorporationsGoverning Documents & ProceduresRecords & Inspection RightsRecordkeepingSecurities
 LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingGeneral
 OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping &
 ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. The National Association of Securities Dealers NASD"predecessor to the Financial Industry Regulatory Authority ("FINRA") founded the NASD Automated Quotation system (the "NASDAQ") in 1971. NASDAQ is now owned and operated by the NASDAQ OMX Group, Inc.

(n2)Footnote 2. NYSE Listed Company Manual § 303.01(B); Nasdaq Rule 4350(d); Amex Company Guide § 121A, *available at* <http://wallstreet.cch.com/AmericanStockExchangeAMEX/AmexCompanyGuide/default.asp>.

(n3)Footnote 3. Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., 29 U.S.C.).

(n4)Footnote 4. *See, e.g.*, Sarbanes-Oxley Act §§ 202 (Preapproval Requirements); 301 (Public Company Audit Committees); 302(a)(5) (requiring CFOs and CEOs to certify that they have disclosed certain matters to the audit committee); 407 (Disclosure of Audit Committee Financial Expert). These and other sections of the Sarbanes-Oxley Act relating to public company outside auditors and audit committees, and related implementing regulations, are reproduced in Appendix D to this treatise. Sarbanes-Oxley Act § 302 and related implementing regulations are reproduced in Appendix E.

(n5)Footnote 5. *See* SEC Releases Nos. 33-8177, 34-47235 (Disclosures Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002) (Jan. 23, 2003); 33-8183, 34-47265 (Strengthening the Commission's Requirements Regarding Auditor Independence) (Jan. 18, 2003); and 33-8220, 34-47654 ("Standards Relating to Listed Company Audit Committees") (Apr. 9, 2003).

(n6)Footnote 6. *See* SEC Release No. 34-48745 (Nov. 4, 2003).



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CHAPTER 9 THE AUDIT COMMITTEE

1-9 Corporate Governance: Law and Practice § 9.02

AUTHOR: Bart Schwartz

§ 9.02 Audit Committee Charter, Scope and Purpose

[1] NYSE Requirements for Audit Committee Charter

The audit committee of a company with securities listed on the NYSE must have a formal written charter including at least the elements enumerated below.ⁿ¹

The audit committee's charter must address the committee's purpose, including, at least, the following:ⁿ²

(A) [to] assist board oversight of (1) the integrity of the listed company's financial statements, (2) the listed company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the listed company's internal audit function and independent auditors; and

(B) [to] prepare an audit committee report as required by the SEC to be included in the listed company's annual proxy statement

While most of these required purposes are statements of either the traditional roles of the audit committee or of responsibilities already required by other rules, the requirement that a purpose of the audit committee be to "assist board oversight of ... the company's compliance with legal and regulatory requirements" added a significant mandatory dimension to the purpose of the audit committee. The board's "duty of oversight" became the subject of widespread attention and comment following Chancellor Allen's now-famous decision in the *Caremark* case.ⁿ³ Following *Caremark*, there was much scholarly debate about the legal status (holding or dictum) of Chancellor Allen's discussion of the "duty of oversight" and whether there is, strictly speaking, such a separate duty (as opposed to the duty of care, explained in different way) under Delaware law. By now, the debate is purely academic. All U.S. public corporations are well-advised to act as though there is a separate duty of oversight, to comply both with state law requirements on the fiduciary duties of directors and with the applicable SRO corporate governance listing standards adopted after passage of the Sarbanes-Oxley Act.ⁿ⁴

The 2003 NYSE corporate governance listing standard quoted above not only explicitly requires the board to take responsibility for overseeing the company's compliance with legal and regulatory compliance (for any company with

securities listed on the NYSE), but it also mandates that the audit committee assist the board with its compliance-oversight role. This requirement, along with a chorus of best practices recommendations from influential groups to the same effect,ⁿ⁵ has significant implications for the agenda and procedures of the audit committee.ⁿ⁶

The 2003 NYSE corporate governance listing standards also mandate that, except in certain specially exempted cases,ⁿ⁷ the audit committee's charter assign to the audit committee at least the duties and responsibilities to:ⁿ⁸

- (i) directly be responsible for the appointment, compensation, retention and oversight of the work of the company's independent auditors (subject, if applicable, to shareholder ratification) and such independent auditors must report directly to the audit committee;
- (ii) establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters;
- (iii) obtain advice and assistance from outside legal, accounting or other advisors as the audit committee deems necessary to carry out its duties;
- (iv) receive appropriate funding, as determined by the audit committee, from the listed company for payment of compensation to the outside legal, accounting or other advisors employed by the audit committee and ordinary administrative expenses that are necessary or appropriate in carrying out its duties;
- (v) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;
- (vi) meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations";
- (vii) discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;
- (viii) discuss policies with respect to risk assessment and risk management;
- (ix) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;
- (x) review with the independent auditor any audit problems or difficulties and management's response;
- (xi) set clear hiring policies for employees or former employees of the independent auditors; and
- (xii) report regularly to the board of directors.

Finally, the audit committee charter for a NYSE-listed company must require the committee to undergo an annual

performance evaluation.ⁿ⁹

A sample charter for the audit committee of a NYSE-listed company is reproduced in Appendix 9-A to this chapter.

[2] NASDAQ Requirements for Audit Committee Charterⁿ¹⁰

The charter for a NASDAQ-listed company audit committee must address at least:ⁿ¹¹

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor;

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the company and the audits of the financial statements of the company;

(D) the following specific audit committee responsibilities and authority necessary to:

(i) directly be responsible for the appointment, compensation, retention and oversight of the work of the company's independent auditors (subject, if applicable, to shareholder ratification) and such independent auditors must report directly to the audit committee;

(ii) establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters;

(iii) obtain advice and assistance from outside legal, accounting or other advisors as the audit committee deems necessary to carry out its duties; and

receive appropriate funding, as determined by the audit committee, from the listed company for payment of compensation to the outside legal, accounting or other advisors employed by the audit committee and ordinary administrative expenses that are necessary or appropriate in carrying out its duties

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law
Corporations
Directors & Officers
Management Duties & Liabilities
General
Overview
Business & Corporate Law
Corporations
Directors & Officers
Scope of Authority
Discretion
Business & Corporate Law
Corporations
Governing Documents & Procedures
Records & Inspection Rights
Recordkeeping
Securities Law
Self-Regulating Entities
National Association of Securities Dealers
Securities Law
Self-Regulating Entities
National Securities Exchanges
New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. See NYSE Listed Company Manual § 303A.07(c). The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.07(c).

(n3)Footnote 3. *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) . *Caremark* is discussed in depth in § 4.03[4] above.

(n4)Footnote 4. For a detailed discussion of the duty of oversight, *see* § 4.03[4] above.

(n5)Footnote 5. *See, e.g.*, Report of the American Bar Association Task Force on Corporate Responsibility 70-71 (Mar. 31, 2003), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, 59 *Bus. Law* 145, 184-85 (2003) [hereinafter ABA Task Force Corporate Responsibility Report] ("The board of directors should charge a committee composed exclusively of independent directors (such as an audit committee or a legal compliance committee) with responsibility to obtain and evaluate regular reports from the corporate officers responsible for implementing the corporation's internal controls, codes of ethics and compliance policies, including general counsel, the chief financial officer, the chief internal auditor and the chief compliance officer, on legal and compliance affairs of the corporation as directed by such committee, including, at a minimum, information about violations or potential violations of law and breaches of fiduciary duty by an executive officer or director that could have a material adverse effect on the corporation.").

(n6)Footnote 6. *See* § 9.04[2][h] below.

(n7)Footnote 7. *See* 17 *CFR* § 240.10A-3(c) (exempting, among other things, (i) at-least-50-percent-beneficially-owned consolidated subsidiaries of the issuer, except those having classes of equity securities other than non-convertible, non-participating-preferred securities; (ii) foreign private issuers with boards of auditors or statutory auditors meeting certain specified criteria, although the audit committees of such foreign private issuers must nevertheless have charters requiring them, among other things, (a) to establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal controls and auditing matters and the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters, and (b) to engage independent advisers as its deems necessary, paid for by the company; (iii) issuers whose only listed securities are (a) futures products cleared by a clearing agency that is either registered under Section 17A of the Securities Exchange Act of 1934 Act (the "1934 Act" or the "Exchange Act") or exempt from such registration pursuant to specified exemptions or (b) standardized options issued by a clearing agency registered under Section 17A; (iv) asset-backed issuers; (v) unit investment trusts; (vi) foreign governments; and (vii) trusts or other unincorporated associations without a board of directors or persons acting in a similar capacity whose activities are limited to passive ownership, administration or distribution of securities or other assets on behalf of or for the benefit of its listed securities).

(n8)Footnote 8. NYSE Listed Company Manual § 303A.07(c)(iii); 17 *CFR* § 240.10A-3(b)(2)-(5).

(n9)Footnote 9. NYSE Listed Company Manual § 303A.07(c)(ii). *See* § 9.04[2][a][vi] below.

(n10)Footnote 10. The audit committee charter requirements for companies listed on the Amex are substantially identical to the NASDAQ requirements. *See* Amex Company Guide § 803B(1).

(n11)Footnote 11. Nasdaq Rule 5605(c)(1). Nasdaq Rule 5605 is reproduced in Appendix C to this treatise.



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CHAPTER 9 THE AUDIT COMMITTEE

1-9 Corporate Governance: Law and Practice § 9.03

AUTHOR: Bart Schwartz

§ 9.03 Audit Committee Composition

[1] Audit Committee Size and Independence

For companies with securities listed on the NYSE, the NASDAQ or the Amex, the boards of directors must have an audit committee consisting of at least three independent directors,ⁿ¹ and the board should make an affirmative determination of the independence of each member of the audit committee.ⁿ²

[a] Audit Committee Independence Standards for All SEC Registrants

[i] General Independence Standards for All SEC Registrants

In addition, for any SEC registrant, no member of an audit committee may:ⁿ³

- directly or indirectly accept any consulting, advisory or other compensatory fee from the issuer or any of its subsidiaries (other than board and committee fees); or
- be an "affiliated person" of the company or any of its subsidiaries.

Indirect acceptance of a consulting, advisory or other compensatory fee includes acceptance of such fee by:ⁿ⁴

- a spouse, a minor child or stepchild or a child or stepchild sharing a home with the audit committee member; or
- an entity in which the audit committee member is a partner, member or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer.

For purposes of audit committee independence, an "affiliated person" is someone who directly, or indirectly through

one or more intermediaries, controls, or is controlled by, or is under common control with, the company,ⁿ⁵ including any executive officer of an affiliate, any director who is also an employee of an affiliate, any general partner of an affiliate and any managing member of an affiliate.ⁿ⁶

A person who, directly or indirectly, owns 10 percent or less of any class of the voting securities--and is not an executive officer--of a company does not "control" that entity for purposes of the audit committee independence test.ⁿ⁷ Nevertheless, this safe-harbor does not create a presumption that a more-than-10-percent owner is a controlling person or an affiliate.ⁿ⁸

[ii] Exemptions From Independence Requirements

An audit committee member who sits on the boards of directors of both a listed issuer and an affiliate of the listed issuer is exempt from the prohibition against audit committee members' being affiliated persons of the company or its subsidiaries if that director otherwise meets the independence requirements, including the requirement that independent directors receive only ordinary-course compensation for serving as member of the board of directors, audit committee or other board committee.ⁿ⁹

After an initial public offering (preceding which the issuer was not an SEC reporting company):ⁿ¹⁰

- all but one of the members of the issuer's audit committee may be exempt from the independence requirements for 90 days following the effective date of the registration statement, and
- a minority of the members of the issuer's audit committee may be exempt from the independence requirements for one year following the effective date of the registration statement.

[iii] Special Independence Requirement Exemptions for Foreign Private Issuers

There are also special exemptions for foreign private issuers. An employee of a foreign private issuer who is not an executive officer of the foreign private issuer is exempt from the independence requirements if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.ⁿ¹¹

In addition, an audit committee member of a foreign private issuer may be exempt from the independence requirements if:

(1)ⁿ¹²

- (a) the member is an affiliate of the foreign private issuer or a representative of such an affiliate;
 - (b) the member has only observer status on, and is not a voting member or the chair of, the audit committee; and
 - (c) neither the member nor the affiliate is an executive officer of the foreign private issuer;
- or

(2)ⁿ¹³

- (a) the member is a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer; and

(b) the member is not an executive officer of the foreign private issuer.

[b] Audit Committee Independence Standards for NYSE Companies

In addition to the specific requirements for the independence of members of audit committees of all SEC registrants, for audit committees of companies with securities listed on the NYSE, the following general director independence rules apply:¹⁴

(i) A director who, in the past three years, has been an employee, or has had an immediate family member who has been an executive officer, of the listed company is not independent.

(ii) A director is not independent if, in any 12-month period within the last three years, he or she has received, or has had an immediate family member who has received, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).¹⁵

(iii) A director is not independent if he or she (A) is a current partner or employee of a firm that is the company's internal or external auditor; (B) has an immediate family member who is a current partner of such a firm; (C) has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (D) was, or an immediate family member was, within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time

(iv) A director is not independent if, within the last three years, he or she has been employed, or has had an immediate family member who has been employed, as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) A director is not independent if he or she is a current employee, or has an immediate family member who is a current executive officer, of a company that has, in any of the last three fiscal years, made payments to, or received payments from, the listed company for property or services in an amount which, in any such year, exceeded the greater of \$1 million or 2 percent of such other company's consolidated gross revenues.

For purposes of these rules, an "immediate family member" includes a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. In addition, when applying the look-back provisions of these rules, listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated.¹⁶

[c] Audit Committee Independence Standards for NASDAQ Companies

In addition to meeting the specific requirements for the independence of the members of audit committees of all SEC registrants, members of audit committees of companies with securities listed on the NASDAQ may not:¹⁷

- be, or in the past three years have been, employed by the company or any parent or subsidiary of the company;

- have, or have a family member who has, accepted any compensation from the company or any parent or subsidiary of the company in excess of \$120,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than:n18

- compensation for board or board committee service;

- compensation paid to a family member who is a non-executive employee of the company or a parent or subsidiary of the company; or

- benefits under a tax-qualified retirement plan, or non-discretionary compensation;

- be a family member of a person who is, or in any of the past three years has been, employed by the corporation or any parent or subsidiary of the company as an executive officer;

- be, or have a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company or any parent or subsidiary of the company made, or from which the company or any parent or subsidiary of the company received, payments for property or services in the current year or any of the past three fiscal years that exceed 5 percent of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, other than

- payments arising solely from investments in the corporation's securities; or

- payments under non-discretionary charitable contribution matching programs;

- be or have been, or have a family member who is or has been employed as an executive officer of another entity where at any time during the past three years any of the listed company's executives officers serve on the compensation committee of such other entity; or

- be, or have a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.n19

For purposes of these rules, "family members" include spouses, parents, children, and siblings, whether by blood marriage or adoption, and anyone else residing in the director's home.n20

[2] Other Attributes for Audit Committee Membership

[a] Audit Committee Financial Expert

Pursuant to an SEC rule implementing Sarbanes-Oxley Section 407, in their annual reports issuers must disclose that they have at least one "financial expert" on their audit committees or, otherwise, explain why they do not.n21

The rule requires each registrant to disclose that its board of directors has determined that its audit committee has *or does not have* at least one audit committee financial expert. Thus, an affirmative determination of the board is required. In this sense, the rule has substantive corporate governance implications--it effectively requires that the question of "financial expertise" on the audit committee be referred to the full board. It would not be sufficient, for example, simply to state that the company has not determined that it has an audit committee financial expert on its audit committee.

Nevertheless, beyond this, like most SEC rules, the rule on audit committee financial experts is a disclosure requirement. It does not require registrants to have financial experts on their audit committees, but only to disclose the board's determination that the audit committee does or does not include such a director and, if not, why not. If the board has determined that its audit committee includes at least one financial expert, it must disclose that person's name and whether he or she is independent, as "independence" is defined in SRO listing standards applicable to the issuer.ⁿ²² If the board determines that it has more than one financial expert on its audit committee, it may (but is not required to) disclose the same information for each such financial expert. If the board determines that a member of the audit committee is a financial expert by reason of that person's "other relevant experience," the registrant must provide a brief listing of such experience, as discussed below.

Under the rule, to qualify as a financial expert, the director must have five attributes acquired in one of four ways. The five attributes are:ⁿ²³

- (i) an understanding of generally accepted accounting principles and financial statements;
- (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- (iii) experience preparing, auditing, *analyzing or evaluating* financial statements that present a breadth and level of complexity of *accounting issues* that are *generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities*;
- (iv) an understanding of internal control over financial reporting; and
- (v) an understanding of audit committee functions.

These attributes may be acquired through one or more of the following:ⁿ²⁴

- (i) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- (ii) *experience actively supervising* a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (iv) *other relevant experience*.

Certain language in the two lists given above is set in bold to emphasize the more flexible aspects of the rule and the degree of latitude that boards have in finding "financial experts" on their audit committees. To understand the degree of flexibility afforded under the rule, it is useful to compare it with the SEC's originally proposed "financial expert" rule, which would have required the director so designated to have experience "*preparing or auditing financial statements* that present accounting issues that are *generally comparable to those raised by the issuer's financial statements*."ⁿ²⁵ The SEC's original proposal would also have stipulated that this (and the other required attributes) be gained "through education and experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer" of a 1934 Act reporting company (or through experience in positions involving "the performance of similar functions" or resulting, in the board's judgment, in "the person's having similar experience and expertise").ⁿ²⁶

In contrast, the final "financial expert" disclosure rule, quoted above, allows the board to give equal credit for "analyzing or evaluating" financial statements presenting accounting *issues generally comparable in breadth and complexity* to those expected to be raised by the registrant's financial statements, or for "actively supervising" a person with these responsibilities. Thus, the rule leaves room for a board to designate a former or sitting CEO as a "financial expert" on its audit committee.

At first blush, the SEC's comments in the final rule release might seem to raise some doubt about this conclusion:ⁿ²⁷

The term "active supervision" means more than the mere existence of a traditional hierarchical reporting relationship Rather, we mean that a person engaged in active supervision participates in, and contributes to, the process of addressing, albeit at a supervisory level, the same general types of issues regarding preparation, auditing, analysis or evaluation of financial statements as those addressed by the person or persons being supervised. We also mean that the supervisor should have experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised. A principle [sic] executive officer should not be presumed to qualify Active participation in, and contribution ... that demonstrates a general expertise in the area would be necessary.

Nevertheless, read together and in context, the text of the rule and the SEC's comments should be interpreted to leave it to the discretion of the board to determine, in its business judgment, whether, for example, a former or sitting CEO of another company, who was never a CPA or a CFO, but to whom CFOs or other financial professionals have reported, has been sufficiently "active" in addressing the necessary sorts of accounting issues and has made a sufficient "contribution" to demonstrate "general expertise in the area" so as to allow the board to conclude that he or she is a financial expert. It should be noted, however, that, in the wake of the accounting scandals of the early part of the millennium, there has been a premium on the recruitment of board members with traditional financial accounting backgrounds to fill the role of the audit committee financial expert.

[b] "Financial Literacy"

In the case of companies with NYSE-listed securities, except foreign private issuers, each member of the audit committee must be "financially literate, as such qualification is interpreted by the listed company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment"; however, a board may presume that a person who satisfies the definition of audit committee financial expert set out in Item 407(d)(5)(ii) of Regulation S-K has accounting or related financial management expertise.ⁿ²⁸

Similarly, in the case of companies with securities listed on NASDAQ, each member of the audit committee must:

be able to read and understand fundamental financial statements, including a Company's balance sheet, income statement, and cash flow statement. Additionally, each Company must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.ⁿ²⁹

[c] Service on No More Than Three Audit Committees

If an audit committee member serves on more than three public company audit committees, at least one of which is a

NYSE company, and if the NYSE company does not limit the number of public company audit committees on which its members may serve to three or fewer, then the board of each such NYSE company must determine that such simultaneous service does not impair the ability of the audit committee member effectively to serve on its audit committee and must disclose that determination in the company's proxy statement (or, if the company does not file a proxy statement, in the company's annual report on Form 10-K).n30

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretionBusiness & Corporate LawCorporationsGoverning Documents & ProceduresRecords & Inspection RightsRecordkeepingSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley ActSecurities LawSelf-Regulating EntitiesNational Association of Securities DealersSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* 17 CFR § 240.10A-3(b)(1); NYSE Listed Company Manual § 303A.07(a)-(b); Nasdaq Rule 5605(c)(2); Amex Company Guide § 803B(2)(a).

(n2)Footnote 2. *See* NYSE Listed Company Manual § 303A.02(a) (requiring that, for a director to be considered independent, the board affirmatively determine and disclose that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)); Nasdaq Rule 5605(a)(2) (defining independent director to mean "a person other than an executive officer or employee of the company or any other individual having a relationship which, *in the opinion of the company's board of directors*, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director" and then listing specific disqualifying circumstances) (emphasis added). The board has a responsibility to make an affirmative determination that no such disqualifying relationships exist. (Nasdaq IM-5605) When combined with the additional requirement that each NASDAQ-listed company "must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must ... be independent as defined under Rule 5605(a)(2) ..." (Nasdaq Rule 5605(c)(2)(A)), the reference to the opinion of the board concerning the absence of relationships that would interfere with the exercise of independent judgment is best interpreted to require the adoption of a formal board resolution, which will also back up the required certification; Amex Company Guide § 803A(2) (requiring affirmative board determination of independence).

(n3)Footnote 3. 17 CFR § 240.10A-3(b)(1)(ii), unless the rules of an applicable SRO provide otherwise, (providing also that compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer, provided that the compensation is not contingent in any way on continued service).

(n4)Footnote 4. 17 CFR § 240.10A-3(e)(8).

(n5)Footnote 5. 17 CFR § 240.10A-3(e)(1)(i).

(n6)Footnote 6. 17 CFR § 240.10A-3(e)(1)(iii).

(n7)Footnote 7. 17 CFR § 240.10A-3(e)(1)(ii)(A).

(n8)Footnote 8. 17 CFR § 240.10A-3(e)(1)(ii)(B).

(n9)Footnote 9. 17 CFR § 240.10A-3(b)(1)(iv)(B) (2005).

(n10)Footnote 10. *17 CFR § 240.10A-3(b)(1)(iv)(A)*.

(n11)Footnote 11. *17 CFR § 240.10A-3(b)(1)(iv)(C)*.

(n12)Footnote 12. *17 CFR § 240.10A-3(b)(1)(iv)(D)*.

(n13)Footnote 13. *17 CFR § 240.10A-3(b)(1)(iv)(E)*.

(n14)Footnote 14. NYSE Listed Company Manual § 303A.02(b).

(n15)Footnote 15. Neither (a) compensation received by the director for former service as an interim Chairman or CEO or other executive officer, nor (b) compensation received by an immediate family member for service as a non-executive employee is required to be taken into account for purposes of this test. NYSE Listed Company Manual § 303A.02(b)(ii) Commentary.

(n16)Footnote 16. NYSE Listed Company Manual General Commentary to § 303A.02(b).

(n17)Footnote 17. Nasdaq Rule 5605(a)(2)(A)-(F). Nasdaq Rule 5605 is reproduced in Appendix C to this treatise.

(n18)Footnote 18. This prong of the rule is generally intended to capture situations where compensation is made directly to, or for the benefit of, the director or family member. Payments made by a company for the benefit of a director, such as political contributions to the campaign of a director or director's family member, would be considered indirect compensation for purposes of this standard. Non-preferential payments made in the ordinary course of providing business services (such as payments of interest or proceeds related to banking services or loans by a company that is a financial institution or payment of claims on a policy by a company that is an insurance company), payments arising solely from investments in the company's securities and loans permitted under Sarbanes-Oxley do not preclude a finding of independence as long as the payments are non-compensatory in nature. Depending on the circumstances, a loan or payment could be compensatory if it is not on terms generally available to the public. *See* Nasdaq IM 5605 (Definition of Independence - Rule 5605(a)(2)).

(n19)Footnote 19. In the case of investment companies, the foregoing independence rules for audit committee members do not apply; instead, no audit committee member may be an "interested" person as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee. Nasdaq Rule 5605(a)(2)(G).

(n20)Footnote 20. Nasdaq Rule 5605(a)(2).

(n21)Footnote 21. *17 CFR § 229.407(d)(5)*.

(n22)Footnote 22. *17 CFR § 229.407(d)(5)(i)(B)*.

(n23)Footnote 23. *17 CFR § 229.407(d)(5)(ii)* (emphasis added).

(n24)Footnote 24. *17 CFR § 229.407(d)(5)(iii)* (emphasis added).

(n25)Footnote 25. Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release No. 34-46701 (Oct. 22, 2002) (emphasis added).

(n26)Footnote 26. Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release No. 34-46701 (Oct. 22, 2002) (emphasis added) at Instruction 1 to Proposed Item 309 of Regulation S-K.

(n27)Footnote 27. SEC Release Nos. 33-8177; 34-47235 at II.A.4.d.iii. (Jan. 23, 2003).

(n28)Footnote 28. NYSE Listed Company Manual § 303A.07(a) Commentary.

(n29)Footnote 29. Nasdaq Rule 5605(c)(2)(A)(iv). There is a substantially similar requirement for audit committee members in Amex-listed companies. *See* Amex Company Guide § 803B(2)(a)(3).

(n30)Footnote 30. NYSE Listed Company Manual § 303A.07(a) Commentary.



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Corporate Governance: Law and Practice

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CHAPTER 9 THE AUDIT COMMITTEE

1-9 Corporate Governance: Law and Practice § 9.04

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§ 9.04 Audit Committee Process and Procedure

[1] General Considerations--Business Judgment Rule

Especially since Enron and the other accounting scandals of the early part of the new millennium, there has been increasing focus and attention on the work of the audit committee. Yet, while there are many new rules relating to audit committees, the fundamental legal duties of audit committee members remain the same. Like other directors, under state law they have a duty of care and a duty of loyalty and, for their decisions to be entitled to the protection of the business judgment rule, they must fulfill both duties.¹ Thus, for example, audit committee members should:

- sufficiently in advance of each meeting to permit careful review, receive all materials relating to the issues to be brought before the committee;
- satisfy themselves that they have all information reasonably available and necessary for careful and thorough consideration of the issues on their agenda;
- take ample time to thoroughly consider all the issues that come before them; and
- when appropriate, seek the advice of experts--including, when necessary, experts who are independent of company management.

[2] Specifically Required Procedures

U.S. public companies have quarterly and annual reporting cycles, and foreign private issuers have at least annual (and sometimes semi-annual or quarterly) reporting cycles, as well. In connection with the public release of earnings and the filing of SEC disclosure documents tied to the regular reporting cycle, it has become customary for each of the participants in the process (including, principally, internal accounting and finance departments, internal audit departments, company management, and outside auditors) to play a prescribed role and to follow certain procedures. Many of these procedures are covered by rules of various bodies with governmental, self-regulatory or professional authority over their constituents--notably, the SEC, the SROs (including principally the NYSE and FINRA) and the American Institute of Certified Public Accountants (the "AICPA") (and its predecessor, the Accounting Standards

Board).

The following discussion will address audit committee procedures, first in connection with the company's regular reporting cycles and then in terms of other procedures required by more recent developments in corporate governance practice and legal and regulatory developments.

[a] Annual Procedures

[i] *Retention of Auditors*

The SEC rules emphasize that the audit committee itself must hire, fire and supervise the outside auditors.ⁿ² As a practical matter, this means that the audit committee should, among other things:

- decide whether to retain the incumbent auditors or to consider other audit firms;
- if a new audit firm is being considered, interview alternative candidates for the assignment and make the final selection (although, in this process, the committee may certainly seek and consider management's input);
- negotiate or review the auditors' fee and the terms of engagement;
- maintain a direct, open line of communication with the auditors (perhaps through the audit committee chair);
- receive the auditors' reports (by following the procedures described below);
- monitor the auditors' performance; and
- make final determinations concerning issues that arise during the course of the audit.

[ii] *Review of Auditor Independence and Quality Control*

Each year, the audit committee must disclose whether it has received the written disclosures and the letter from the independent accountants required by applicable requirements of the Public Company Accounting Oversight Board ("PCAOB").ⁿ³ The current standard requires, at least annually and prior to accepting an initial engagement, that the independent auditors:ⁿ⁴

- a. describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the issuer or persons in financial reporting oversight roles at the issuer that, as of the date of the communication, may reasonably be thought to bear on independence;
- b. discuss with the audit committee of the issuer the potential effects of the relationships described in subparagraph (a) above on the independence of the registered public accounting firm;
- c. affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with PCAOB Rule 3520; and
- d. document the substance of its discussion with the audit committee of the issuer.

In addition, for NYSE companies, the audit committee must:

at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company.ⁿ⁵

[iii] Review of Financial Statements and Disclosures

One of the key responsibilities of the audit committee is to review the periodic (including annual) financial statements. In this regard, the charter of a NYSE company must enumerate the audit committee's responsibility to:

meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the company's specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" ...ⁿ⁶

For a NASDAQ company, the audit committee charter must specify "the committee's purpose of overseeing the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company."ⁿ⁷ It is difficult to see how an audit committee could fulfill this purpose without meeting with management and with the outside auditors to review and discuss the quarterly and annual financial statements before they are issued. Moreover, annually, the audit committee of every SEC registrant must disclose whether it has "reviewed and discussed the audited financial statements with management."ⁿ⁸

The normal and customary process is for a draft of the Annual Report on Form 10-K to be distributed to the audit committee members in advance of the meeting to enable them to review it carefully. At the meeting, which ordinarily takes place sufficiently close to the filing deadline that the document is essentially in final form (subject to any committee comments), the CFO, controller or chief accountant, sometimes the CEO, and sometimes other invited participants (such as major business unit heads), go through the major elements of the financial statements and the MD&A disclosures. The committee discussion then proceeds in open session with management, in executive session with the chief internal auditor, and in executive session with only the outside auditors.ⁿ⁹

Of course, in these discussions, the audit committee members should raise any pertinent questions and, if appropriate, discuss the possibility of changes or alternative treatments. It is in connection with this sort of probing of the numbers, choices of accounting policies, accounting estimates and textual disclosures in the MD&A that the audit committee plays one of its most critical roles. This aspect of the process has become the subject of a number of overlapping rules and pronouncements.ⁿ¹⁰

Because a majority of the directors must sign the Annual Report on Form 10-K, and to enable the board to fulfill its overall role, the Form 10-K is normally distributed, in close-to-final form, to all directors, and a second review of the financial statements and of the MD&A is conducted in a meeting of the full board following the audit committee meeting (often the next day). In that meeting, the outside directors who are not on the audit committee are entitled to place some reliance on the fact that the audit committee has gone through a thorough review of these matters.ⁿ¹¹

[iv] Review of Accounting Policies, Alternative Treatments and Written Communications Between Management and the Auditors

While, strictly speaking, it governs the duties of registered auditors, rather than audit committees, one SEC rule adopted pursuant to the Sarbanes-Oxley Act has important implications for the agenda of the audit committee's annual

discussion of the Form 10-K, including the company's audited financial statements and the MD&A. It provides that any registered public accounting firm that performs an audit for an issuer must annually report to the audit committee (and, if the annual report--which may be written or oral--is not within 90 days prior to the pertinent SEC filing, must provide an update, within that 90 day period, of any changes to previously reported information) the following items:¹²

- (1) all critical accounting policies and practices to be used;
- (2) all alternative treatments within Generally Accepted Accounting Principles for policies and practices related to material items that have been discussed with management of the issuer or registered investment company, including:
 - (a) ramifications of the use of such alternative disclosures and treatments; and
 - (b) the treatment preferred by the registered public accounting firm;
- (3) other material written communications between the registered public accounting firm and the management of the issuer or registered investment company, such as any management letter or schedule of unadjusted differences;
- (4) if the audit client is an investment company, all non-audit services provided to any entity in an investment company complex, as defined in *17 CFR § 210.2-01(f)(14)*, that were not pre-approved by the registered investment company's audit committee pursuant to *17 CFR § 210.2-01(c)(7)*.

This list overlaps, but does not strictly track, the auditor's responsibility under Statement on Auditing Standards No. 114 ("SAS 114")¹³ Since, in addition, the company is required to disclose whether the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 114,¹⁴ in effect the SAS 114 items are required discussion topics for the audit committee.¹⁵ In addition to the topics required to be addressed under the SEC rule discussed above, the SAS 114 topics include:

- the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures [normally taken to mean where they fall on the spectrum of aggressive to conservative];
- significant difficulties, if any, encountered during the audit;
- uncorrected misstatements, other than those the auditor believes are trivial, if any;
- disagreements with management, if any;
- other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process;
- material, corrected misstatements that were brought to the attention of management as a result of audit procedures;
- representations the auditor is requesting from management
- management's consultations with other accountants;

- significant issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management; and
- significant difficulties encountered in dealing with management related to the performance of the audit, such as:
 - significant management delays in providing required information;
 - unnecessary time constraints on the completion of the audit;
 - extensive unexpected effort required to obtain sufficient appropriate audit evidence;
 - unavailability of expected information;
 - management-imposed restrictions on the auditors; or
 - management's unwillingness to provide information about management's plans for dealing with the adverse effects of the conditions or events that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern.

The normal practice among major public accounting firms acting as independent auditors to U.S. public companies is to produce a written document covering all such required communications, and to discuss at length with the audit committee any issues that merit special attention.

[v] *Audit Committee's Role in Annual Internal Control Review and in Disclosure Control Review*

Under Sarbanes-Oxley Section 404 and the SEC regulations thereunder, each annual report filed required by Section 13(a) or 15(d) of the 1934 Act must contain an internal control report that:¹⁶

- (1) states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- (2) contains an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

In addition, each registered accounting firm that prepares or issues the audit report for the issuer must "attest to, and report on, the assessment made by the management for the issuer."¹⁷

While neither the statute nor the regulations assign any specifically required role to the audit committee in connection with the annual internal control assessment and attestation, in the adopting release the SEC stated that, "[t]he preparation of the management report on internal control over financial reporting will likely involve multiple parties, including senior management, internal auditors, in-house counsel, outside counsel and audit committee members."¹⁸ Given the audit committee's overall role and responsibilities, it is likely that most audit committees will take a significant interest in reviewing the annual Section 404 management internal control assessment, the auditor's attestation, and the process by which both were arrived at. As a result, presentations by management and the attesting independent auditors on the Section 404 internal control report and attestation are appropriate annual audit committee agenda items--and are likely to become the norm--for the meeting preceding the filing of the Company's Annual Report on Form 10-K (or its equivalent for foreign private issuers or Canadian issuers--the Annual Report on Form 20-F or 40-F).

Similarly, under Sarbanes-Oxley Section 302 and its implementing regulations,ⁿ¹⁹ issuers are required to maintain disclosure controls and procedures and, with the filing of each annual or quarterly report under the 1934 Act, the principal executive officer and the principal financial officer (or persons performing similar functions) must certify, among other things, that:

- they are responsible for establishing disclosure controls and procedures;
- they have evaluated the effectiveness of the company's disclosure controls and procedures within the preceding 90 days; and
- they have presented, in the report, their conclusions about the effectiveness of the company's disclosure controls and procedures.

"Disclosure controls and procedures" are defined to include controls and procedures to ensure that the information required to be disclosed in the issuer's reports filed under the 1934 Act is "recorded, processed, summarized and reported" within the prescribed time periods, including "controls and procedures designed to ensure that ... [such information] is accumulated and communicated to the issuer's management, including its principal executive officer ... and its principal financial officer" in a timely manner.ⁿ²⁰ While there is no required role for the audit committee in the review of disclosure controls and procedures, it is appropriate for the CEO and the CFO to report to the audit committee periodically on the company's disclosure controls and procedures. As a matter of internal policy, companies may wish to include in the audit committee charter some role for the committee in reviewing disclosure controls and procedures.

[vi] Audit Committee Performance Evaluation

Like the board as a whole and the other board committees required to be comprised entirely of independent directors, the audit committee of a NYSE company is required, in its charter, to provide for an annual evaluation of the committee's performance.ⁿ²¹ Although the NYSE corporate governance rules do not specify what body must conduct the evaluation, the possibilities include the audit committee itself, the corporate governance and nominating committee, the board as a whole, the non-management directors, or even an outside advisor (such as a law firm or accounting firm--although, in the latter instance, it should not be the company's regular outside independent audit firm, as that would raise independence issues--brought in to review and report on the audit committee's performance over the previous year). The Conference Board recommends that the annual evaluation be conducted by the audit committee itself.ⁿ²²

There is no set formula for the performance evaluation. Some companies require each audit committee member annually to complete a questionnaire assessing the committee's performance on specified tasks and responsibilities while others conduct the evaluation orally.ⁿ²³ When written questionnaires are used, the questionnaires are collected and the responses are reviewed and discussed at an audit committee meeting. Alternatively, or in addition, the responses can be provided to the corporate governance and nominating committee for review and discussion of the audit committee's performance.

[b] Quarterly Procedures

Prior to being filed with the SEC, interim financial statements included in quarterly reports on Form 10-Q must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews.ⁿ²⁴ While this requirement does not directly implicate any audit committee process, it does so indirectly, since the professional standards under which auditors conduct such reviews--set forth in Statement on Auditing Standards No. 100 ("SAS 100")ⁿ²⁵ (since December 15, 2002; and SAS 71 before that date)--require the independent auditors to discuss certain matters with the audit committee (discussed below). In addition, the charter of each NYSE-listed company must specify the committee's responsibility to "meet to review and discuss the listed company's annual audited

financial statements and quarterly financial statements with management and the independent auditor, including reviewing the company's specific disclosures under 'Management's Discussion and Analysis of Financial Condition and Results of Operations'"n26

The accounting industry's professional standards require auditors conducting a review of interim financial information to report to the audit committee:

- (a) material modifications required to bring the interim financial information into conformance with generally accepted accounting principles (if they have brought these issues to the attention of management and management has not responded appropriately within a reasonable time);n27
- (b) the filing of a Form 10-Q or Form 10-QSB before the completion of the review (if they have brought this circumstance to the attention of management and management has not responded appropriately within a reasonable time);n28
- (c) frauds involving senior management or resulting in a material misstatement of the financial statements;n29
- (d) possible illegal acts, unless the matter is clearly inconsequential;n30 and
- (e) matters that, in their judgment, represent significant deficiencies in the design or operation of internal controls that could adversely affect the organization's ability to initiate, record, summarize, and report financial data consistent with management's assertions in the interim financial information ("reportable conditions").n31

In addition, in conducting a review of interim financial information, the accountant is required to communicate with the audit committee, or be satisfied through discussion with the audit committee that management has discussed with the audit committee, those items described in SAS 114 (superseding SAS 61) as they relate to the interim financial information (such as, for example, selection of or changes in significant accounting policies, accounting for unusual transactions, the effect of significant accounting policies in controversial or emerging areas, sensitive accounting estimates, adjustments arising from the audit that could, in the auditor's judgment, create disagreements between the auditors and management, major issues discussed by the auditors and management prior to retention including discussions regarding the application of accounting principles and auditing standards).n32

[c] Approval of Auditor Services

Sarbanes-Oxley and the SEC regulations issued thereunder added detailed requirements for audit committee pre-approval of audit services and permissible non-audit services.n33 Under the regulations, an accountant is not considered independent of an issuer or registered investment company (as the case may be) unless either:n34

- (A) before the accountant is engaged to render audit or permissible non-audit services,n35 the engagement is approved by the audit committee;
- (B) the engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee, as long as (1) the policies and procedures are detailed as to the particular service, (2) the audit committee is informed of each service, and (3) such policies and procedures do not include delegation to management of the statutory responsibilities of the audit committee; or
- (C) the engagement satisfies a very narrow *de minimis* exception (discussed below) relating to certain

services provided by the independent accountant.

The exception (mentioned in (B), above) for services entered into pursuant to pre-approval policies and procedures established by the audit committee must be read in conjunction with Sarbanes-Oxley Act Section 202, which provides, in addition, that the audit committee may delegate the pre-approval requirement to one or more designated audit committee members who are independent directors, but goes on to specify that "the decisions of any member to whom authority is delegated under this paragraph to pre-approve an activity ... shall be presented to the full audit committee at each of its scheduled meetings."³⁶

If the audit committee elects to adopt pre-approval policies and procedures governing the services that may be provided by the outside auditor, rather than approving these services on a case-by-case basis, there are several important issues for the committee to consider:

(1) The pre-approval policies and procedures must be sufficiently "detailed as to the particular service" to be performed by the outside auditor. To incorporate the necessary detail into the policy, the audit committee should be informed of the types of services that the outside auditor has provided to the company in the past and the types of services that management anticipates the outside auditor may be engaged to provide in the coming year. The audit committee can then use this information to determine and specify in the policy which services it will pre-approve. In the pre-approval policy, the pre-approved services should be described in sufficient narrative detail to allow an otherwise uninitiated third-party reader to determine whether any particular service has, in fact, been pre-approved.

(2) In their pre-approval policies, some audit committees also include monetary thresholds to aid in their oversight of the relationship with the outside auditor. An audit committee could establish a cap for each category of service, or it could set an aggregate threshold that applied to all services provided by the outside auditor; for any services that exceed the established thresholds, management would be required to go back to the audit committee for specific pre-approval before the outside auditor could be engaged to perform the service.

(3) The pre-approval policy and procedures should specify the time frame within which the services will be deemed to have been pre-approved. In this regard, unless a specific service that is scheduled to continue for several years is specifically pre-approved, the policy should note that the services to be provided by the outside auditor have been pre-approved by the audit committee only to the extent that they are provided within the company's next fiscal year.

(4) The pre-approval procedures should specify whether management should turn to the entire audit committee or just an individual member of the audit committee (such as the audit committee chairperson) if a service that falls outside the scope of the policy needs to be pre-approved. If the policy designates an individual member of the audit committee to pre-approve specific services, then he or she must report back to the entire audit committee at the next scheduled meeting on the specific services approved between meetings.

The *de minimis* exception (mentioned in (C), above) is extremely narrow. The most restrictive element of the exception, and the one that will make its applicability rare, is the requirement that the issuer (or registered investment company) not have recognized at the time of the engagement that the services in question were non-audit services.³⁷ In addition:³⁸

(1) the aggregate amount of all such services provided may constitute no more than five percent of the company's total payments to the independent accountant during the fiscal year in which such services are provided; and

(2) such services must promptly be brought to the attention of the audit committee and must be approved before the completion of the [presumably, ongoing or next] audit by the committee or one or more of its members to whom the committee has delegated the authority to grant such approvals.

In addition, the PCAOB has adopted a rule requiring that, for a public company's outside auditors to be considered independent, audit committees follow certain procedures in connection with the retention of such auditors for tax-related services.ⁿ³⁹ The rule provides that, in seeking audit committee pre-approval to perform a permissible tax service, a registered public accounting firm shall:

(a) describe, in writing, to the audit committee of the issuer --

(1) the scope of the proposed service, the fee structure for the engagement, and any side letter, other amendment to the engagement letter, or other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service; and

(2) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service;

(b) discuss with the audit committee the potential effects of the services on the independence of the firm; and

(c) document the substance of its discussion with the audit committee.

[d] Approval of Related-Party Transactions

In 2006, the Securities and Exchange Commissions adopted amendments to its rule for public companies' disclosures of related party transactions.ⁿ⁴⁰ One of the 2006 reforms was the requirement that every public company disclose its policies and procedures for review, approval or ratification of related-party transactions of the sort that are required to be disclosed in the company's annual disclosure documents.ⁿ⁴¹ While no particular approval policies or procedures are required under the SEC's rules, both for protection under state lawⁿ⁴² and to have a process that is appropriate and can be disclosed without risk of criticism under the federal securities laws, companies are well-advised to have a policy that all related-party transactions must be approved in advance by a committee of non-management directors (without the participation or vote of any director who may have an interest in the transaction). The Audit Committee is sometimes the choice for this assignment; however, the governance committee may be the appropriate choice for this assignment because it generally makes recommendations with respect to whether the directors meet the applicable independence standards.

[e] Responsibilities in Connection with Press Releases and Analyst Guidance

While the charter of every NYSE-listed company must specify the committee's duty to discuss earnings press releases, financial information and earnings guidance provided to analysts and rating agencies, the committee may do so generally (by discussing the types of information to be disclosed and the type of presentation to be made). The audit committee is not required to have a discussion in advance of each earnings release or each instance in which a company may provide earnings guidance.ⁿ⁴³ Nevertheless, as to earnings releases, it is good practice, and is common, for the audit committee to review a draft of the press release along with the quarterly or annual report.

[f] Receipt, Retention and Processing of Complaints

Under the Sarbanes-Oxley Act and the SEC's implementing rules, each public company audit committee must establish procedures for:ⁿ⁴⁴

- (i) the receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and
- (ii) the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.

Companies have adopted various approaches to fulfilling this requirement. Some companies have set up areas of their websites with the necessary security measures to allow employees or any other interested parties to submit concerns anonymously, and with links allowing such concerns to be transmitted to all non-management directors or to the members of the audit committee only. In this manner, an integrated procedure may be used to satisfy both the requirement that the audit committee establish whistle-blower procedures and the requirement that the company establish a method (which must be disclosed in the annual proxy statement or, for companies that do not file a proxy statement, the Form 10-K) for interested parties to make their concerns known to the presiding director or the non-management directors as a group.ⁿ⁴⁵ In addition, for a fee, a number of independent service providers will set up a 1-800 "hot line" (with the number being communicated to employees and others by means of the company's intranet and website, among other communications) and staff it with trained employees who are available to receive, record and transmit to the appropriate recipients (including outside directors or the members of the audit committee, when appropriate) complaints or concerns from employees or other parties.

In either case, to fulfill the first prong of the audit committee requirement set forth above, the audit committee must ensure that there are proper procedures in place for the retention and treatment of such complaints and concerns, including for the initiation and completion of an appropriate investigation. As part of this process, audit committees often are provided with a list or summary of the complaints and concerns on a quarterly basis.

When the committee considers to whom such complaints and concerns should be referred in the first instance for investigation, the answer may depend on the nature of the issue. The audit committee may wish to refer complaints or concerns that do not implicate any wrongdoing on the part of senior management to the office of the general counsel, the chief compliance officer or chief internal auditor to investigate and report back to the committee. For complaints and concerns that implicate wrongdoing on the part of senior management, it may be appropriate for the audit committee to engage independent counsel (other than a law firm with which the company has an ongoing relationship) to conduct an investigation. For U.S. companies, one advantage of having counsel (in-house or outside, as the case may be), rather than the internal audit staff, conduct the investigation and report to the committee is that the report, as well as the notes of counsel, can potentially be protected from discovery under the attorney-client privilege and the attorney work-product doctrine.ⁿ⁴⁶ Because local law varies on questions of privilege (and because, for example, in some non-U.S. jurisdictions there is no attorney-client privilege for in-house counsel at all), the audit committee should consult with counsel on the effect on privilege and confidentiality of assigning the investigation to various parties (under either attorney-client privilege or the self-evaluative privilege available in some states) before settling on the prescribed procedure for an investigation to be conducted in a particular jurisdiction.

As far as retention of complaints and concerns, the regulations do not provide any specific guidance. In the absence of such guidance it may be prudent for companies to retain such complaints and concerns (in either paper or electronic format) verbatim and indefinitely.

In light of the whistle-blower-protection provisions of Sarbanes-Oxley,ⁿ⁴⁷ the procedures that audit committees establish for treatment of such complaints and concerns should include a clear statement that no employee may be discharged, demoted, suspended, threatened, harassed or otherwise discriminated against in the terms and conditions of

employment because of any information, complaint or concern regarding questionable accounting or auditing matters he or she has submitted, directly or indirectly, to the audit committee, to any representative or agent of the company, to any government regulatory or law enforcement authority, or to any member of Congress or any committee of Congress.

When complaints and concerns are submitted anonymously (including to any intermediary operating a hot line), the investigator will be unable to follow up directly with the person who submitted the complaint or concern. For this reason, it is advisable at least to provide an option (though not a requirement) for those who submit complaints or concerns to give their names and telephone numbers or e-mail addresses, with assurances that there will be no adverse consequences as a result of providing such information. Alternatively (or in addition), some third-party intermediaries (such as hot-line providers) also provide investigation services and give assurance to the person submitting the complaint or concern that his or her identity will not be revealed to the company. Another procedure often employed when a caller wishes to remain anonymous and when the hot-line operator refers the anonymous complaint to the company for investigation is for the hot-line operator to assign a case number and to invite the caller to call back at an appointed time to receive a report on the results of the company's investigation.

Finally, audit committees may wish to establish a policy concerning categories of complaints that must be reported to the chair of the audit committee promptly (*e.g.*, within two business days). Such categories might include:

- (1) allegations of alleged wrongdoing on the part of executive officers concerning accounting, internal controls or auditing matters;
- (2) allegations concerning false and misleading book entries, financial misstatements or errors, if they could materially affect the accuracy or completeness of the company's financial statements or if there is credible evidence that any such falsifications were deliberate and involved executive officers or employees with significant involvement in internal controls;
- (3) allegations of an intentional fraud or breach of law involving financial reporting; and
- (4) allegations of intentional wrongdoing asserted as part of a wrongful discharge or "whistleblower" claim by an employee, former employee or his or her attorney.

[g] Counsel and Consultants

For SEC registrants, each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.ⁿ⁴⁸ In turn, each listed issuer must provide for appropriate funding, as determined by the audit committee, for payment of:ⁿ⁴⁹

- (i) compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer;
- (ii) compensation to any independent counsel and other advisers engaged by the audit committee; and
- (iii) ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.ⁿ⁵⁰

It is not common for audit committees routinely to retain their own counsel absent special circumstances, although some have done so.ⁿ⁵¹

[h] CEO and CFO's Duties to Discuss Fraud and Material Control Weaknesses

Under the Sarbanes-Oxley statutory and regulatory certification requirements, every registrant's CEO and CFO must, with the submission of each annual and quarterly periodic financial report filed with the SEC (*e.g.*, Forms 10-K and 10-Q), certify, among other things, that they have disclosed to the company's independent auditors and its board audit committee (or persons performing the equivalent functions):ⁿ⁵²

- (i) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and
- (ii) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

While these requirements are couched in terms of the disclosure requirements in the certification of the CEO and CFO to be included as an exhibit to each applicable periodic report, they imply a reciprocal duty of the audit committee to discuss these matters, as applicable in any period, with the CEO and CFO. It is therefore good practice to include on the agenda of the audit committee for each meeting at which the committee reviews a periodic report to be filed with the SEC--perhaps during the committee's executive session with the CEO and CFO--a standard item covering whether these officers have any knowledge of (i) significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that could adversely affect the registrant's ability to record, process, summarize, and report financial information, or (ii) any fraud, whether or not material, involving management or other employees with a significant role in the company's internal control over financial reporting.

[i] Oversight of Compliance and Risk Management

[i] *Audit Committee's Role in Compliance Oversight*

As noted above, the 2003 NYSE corporate governance rules represented the first attempt of any government agency or (in this case) SRO to codify the role of the audit committee in assisting with "board oversight of ... the company's compliance with legal and regulatory requirements" ⁿ⁵³

There are no regulations or SRO rules specifying how the audit committee should carry out this responsibility. Adhering to some of the other procedural requirements (such as the duty of the CEO and CFO to report to the audit committee significant deficiencies and material weaknesses in internal control over financial reporting and frauds involving management or others with a significant role in internal control over financial reporting, and the audit committee's responsibility to establish procedures for receipt, retention and treatment of complaints and concerns relating to accounting, internal controls or auditing matters) should at least partially satisfy the audit committee's duty of oversight. Nevertheless, no rule defines what more is required to satisfy the audit committee's role in assisting board oversight of compliance with legal requirements. ⁿ⁵⁴

In some companies, the chief compliance officer reports directly to the audit committee, with a dotted line to the CEO. Whatever the reporting relationship, the audit committee should hear periodically from the company's head of internal audit, chief compliance officer (if any) and the chief legal officer concerning the company's policies and procedures to promote compliance with applicable laws and regulations and to detect and remedy any violations. ⁿ⁵⁵

In addition, it is customary and appropriate for the company's chief legal officer to brief the board (as a whole, rather than the audit committee) on major legal, regulatory and compliance issues. The directors should be satisfied that the company is addressing these issues responsibly. ⁿ⁵⁶

Before the corporate governance reforms of 2002 and 2003, it had not been traditional in U.S. companies for the audit committee to meet separately and privately with the chief legal officer. Nevertheless, in the post-Enron era, doing so has

become a recommended best practice.ⁿ⁵⁷

[ii] Relationship of Attorney-Conduct Rules to Audit Committee's Role

In considering the audit committee's role in compliance oversight, it is also useful to consider the SEC's 2003 attorney-conduct rules, adopted pursuant to Section 307 of Sarbanes-Oxley, including the "qualified legal compliance committee" procedure under those rules.ⁿ⁵⁸

Under the attorney-conduct rules, when a lawyer appearing and practicing before the Commissionⁿ⁵⁹ in the representation of an issuer becomes aware of evidence of a material violationⁿ⁶⁰ by the issuer or its officers, directors, employees or agents, the lawyer must report the evidence to the issuer's chief legal officer ("CLO") or to both the CLO and the CEO. The CLO must inquire into the evidence that he or she reasonably believes is appropriate to determine if the material violation described in the attorney's report has occurred, is ongoing, or is about to occur.

If the CLO determines no material violation has occurred, is ongoing, or is about to occur, the CLO must notify the reporting attorney and advise the reporting attorney of the basis for the determination. If the CLO in a company without a qualified legal compliance committee (a "QLCC") believes that a material violation has occurred, is ongoing or is about to occur, the CLO must take all reasonable steps to cause the issuer to respond appropriately and must advise the reporting attorney; if the issuer has created a QLCC before a material violation has been reported, the CLO may refer the request to the QLCC, rather than taking ongoing responsibility for the inquiry.ⁿ⁶¹

After an attorney reports a material violation to a CLO in a company without a QLCC, if the CLO or CEO provides an appropriate and timely response the reporting attorney's duties under the attorney-conduct rules are satisfied. If the reporting attorney does not reasonably believe the response is appropriate and reasonably timely, though, he or she must report the material violation "up the ladder":

- (i) to the audit committee of the issuer's board of directors;
- (ii) if the issuer's board of directors does not have an audit committee, to another committee of the issuer's board of directors consisting solely of outside directors; or
- (iii) if the issuer's board of directors does not have a committee consisting solely of non-employee directors, to the issuer's board of directors.

A duly qualified QLCC is a committee (which also may be an audit or other committee)ⁿ⁶² consisting of at least one member of the issuer's audit committee (or if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more additional outside directors that meets certain procedural requirements.ⁿ⁶³

Thus, one way or the other, the audit committee may become involved in issues arising as a result of the SEC attorney-conduct rules: some companies may designate the audit committee as a QLCC (and, even if a company decides to establish a separate committee, at least one audit committee member may be on it) or else the audit committee may become the recipient of "up-the-ladder" reports of evidence of material violations that are not timely and satisfactorily handled at a lower level.

[iii] Audit Committee's Role in Risk Management

The audit committee also has oversight responsibility in the area of risk management, broadly defined. The NYSE 2003 corporate governance rules require audit committees to "discuss policies with respect to risk assessment and risk management ...".ⁿ⁶⁴ The NYSE's commentary goes on to explain:

While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.n65

This is a broad mandate, since risk has many dimensions. In its narrowest sense, the field of risk management has traditionally been understood to encompass the activity of purchasing insurance and managing the company's insurance program to protect the company's assets and the value of the company's business against the economic consequences of fortuitous catastrophic losses and liabilities. More recently, particularly in the wake of the financial crisis that unfolded in 2008, the field of risk management has been viewed in a broader perspective as the process of identifying and managing all major risks to the company--not only traditional catastrophic risk but, for example, financial and even reputational risks, as well, and not only through the purchase of insurance.n66

At a minimum the audit committee's mandate to understand the company's risks and oversee risk management implies that, in companies with professional risk managers (as there are in many large companies these days), the risk manager should meet periodically with the audit committee to review the company's total risk profile and risk management program. In companies without professional risk managers, the issue of risk management should be at least a periodic (for example, annual) agenda item for the audit committee. Members of management (such as the CFO or the head of internal audit) may make their own risk management presentations to the audit committee and they may also wish to bring in outside risk management consultants to address the committee. Although the audit committee has an integral role to play in overseeing risk management, it performs this responsibility in close coordination with the company's professional risk managers, if any, and the company's management, other board committees (*e.g.*, a separate risk committee if the company has one) and the full board. Steps that the audit committee, another appropriate committee or the full board can take to assess risk and satisfy itself that the company's management has conducted an appropriate risk analysis include:

- determining whether the audit committee or the board possesses the expertise needed to understand risks facing the company;
- confirming that management is providing the audit committee and the board with the information it needs to evaluate management's handling of risk;
- confirming that management has an effective process in place to identify, manage, and assess risks;
- confirming that any guidance given to management is aligned with the company's strategy and risk appetite;
- meeting privately with chief risk officer, if any, chief compliance officer, and other senior managers who have insight into the risks facing the company;
- evaluating management's assessment of the risk implications of any new corporate undertaking,

such as an acquisition or a new line of business, and the steps they are proposing to address those risks;

- evaluating with management whether the audit committee or the board is comfortable with the level of risk that management is taking;
- assessing the company's credit and counterparty risks and liquidity risks; and
- treating risk assessment and risk management as an ongoing responsibility and continuously look for warning signs.

[iv] Audit Committee Disclosure Requirements

A U.S. public company must include certain information relating to the audit committee in its annual proxy statement.ⁿ⁶⁷

The company must state in its annual proxy statement whether it has a separately-designated standing audit committee established in accordance with the Exchange Act, or a committee performing similar functions, and it must identify each member of such committee, state the number of meetings it held during the last fiscal year and briefly describe its functions.ⁿ⁶⁸ The company must also state whether or not the audit committee has a charter and, if so, provide the web address where it may be accessed online or include a copy as an appendix to the proxy statement, unless a copy has been included as an appendix to the registrant's proxy statement within the registrant's past three fiscal years.ⁿ⁶⁹

If the listing standards applicable to the company contain independence requirements for audit committees, then the company must identify each member of the audit committee that is not independent under such standards, disclose the nature of the relationship that makes such individual not independent and the reasons such person was nonetheless appointed to the audit committee.ⁿ⁷⁰

The company must also state that the board has made a determination as to whether the audit committee does or does not have at least one financial expert.ⁿ⁷¹ If it states that the audit committee *does* have a financial expert, the company must disclose the name of such expert and whether or not that person is independent (as independence is defined in the listing standards applicable to the company). If it states that the audit committee *does not* have a financial expert, the company must explain why this is the case.ⁿ⁷²

In the annual proxy statement, the audit committee must state:ⁿ⁷³

- (1) whether the audit committee has reviewed and discussed the audited financial statements with management;
- (2) whether the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61 (Codification of Statements on Auditing Standards, AU § 380), as amended;ⁿ⁷⁴
- (3) whether the audit committee has received the written disclosures and the letter from the independent accountants required the Public Company Accounting Oversight Board and has discussed with the independent accountant the independent accountant's independence; and
- (4) whether, based on the review and discussions referred to above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-K (or, for registered closed-end investment companies, the annual report to shareholders required by Section 30(e) of the Investment Company Act of 1940) for the last fiscal year for filing with

the Commission.

The name of each member of the company's audit committee (or, in the absence of an audit committee, the board committee performing equivalent functions or the entire board of directors) must appear below the body of the report.ⁿ⁷⁵

Investment companies registered under the Investment Company Act of 1940,ⁿ⁷⁶ need not provide the information listed above but must furnish the information required by Item 22(b) of Schedule 14A.ⁿ⁷⁷

In addition, the issuer is required to make a series of disclosures in its proxy statement relating to fees paid to independent accountants for various classes of services and audit committee approval of audit and non-audit services provided by independent accountants. In particular, the issuer is required to:

(1) disclose, under the caption "Audit Fees," the aggregate fees billed by the principal accountant for each of the last two fiscal years for the audit of the registrant's annual financial statements and review of quarterly financial statements included in the registrant's Form 10-Q or 10-QSB or services normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years;ⁿ⁷⁸

(2) disclose, under the caption "Audit-Related Fees," the aggregate fees billed by the principal accountant in each of the last two fiscal years for assurance and services that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under "Audit Fees," and a description of the nature of such services;ⁿ⁷⁹

(3) disclose, under the caption "Tax Fees," the aggregate fees billed by the principal accountant in each of the last two fiscal years for professional services rendered for tax compliance, tax advice, and tax planning, and a description of the nature of such services;ⁿ⁸⁰

(4) disclose, under the caption "All Other Fees," the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported under the captions mentioned in [subparagraphs (1)-(3), above], and a description of the nature of such services;ⁿ⁸¹

(5) disclose the audit committee's pre-approval policies and procedures;ⁿ⁸²

(6) disclose the percentage of services described in each of [subparagraphs (2) through (4) above] that were approved by the audit committee pursuant to *17 CFR 210.2-01(c)(7)(i)(C)*;ⁿ⁸³

(7) if greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees;ⁿ⁸⁴

(8) if the registrant is an investment company, disclose the aggregate non-audit fees billed by the registrant's accountant for services rendered to the registrant, and to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides ongoing services to the registrant for each of the last two fiscal years of the registrant;ⁿ⁸⁵ and

(9) if the registrant is an investment company, disclose whether the audit committee of the board of directors has considered whether the provision of non-audit services that were rendered to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant that were not pre-approved pursuant to *17 CFR 210.2-01(c)(7)(ii)* is compatible with maintaining the principal accountant's independence.ⁿ⁸⁶

In its annual report on Form 10-K, the company must disclose "(i) ... the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(i) of Rule 2-01 of Regulation S-X ... [and (ii)] the percentage of services described in each of Items 9(e)(2) through 9(e)(4) of Schedule 14A that were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X."ⁿ⁸⁷

[3] Other Audit Committee Best Practices Recommendations

[a] Initial Orientation and Continuing Education

Especially in view of the increase in audit committee responsibilities brought about by the 2003 corporate governance reforms, influential business groups and others have emphasized the importance of both a formal initial orientation and continuing education for audit committee members.ⁿ⁸⁸ There are a number of commercial and not-for-profit organizations that offer seminars for audit committee members. In addition, several vendors now offer online training modules for audit committee members.

[b] Audit Committee Agenda and Meetings

There is no rule or best practice standard prescribing a specific number of audit committee meetings required, but the minimum number necessary to discharge the audit committee's responsibilities in U.S. companies is generally four (at least one in connection with each quarterly SEC filing and earnings announcement) with most audit committees holding between six and eight meetings per year.ⁿ⁸⁹

The Audit Committee Responsibilities Calendar and Checklist, reproduced in Appendix 9-B to this chapter, is a useful tool for preparing audit committee meeting agendas and allocating the audit committee's responsibilities throughout the year. A typical calendar and/or checklist addresses the items that the audit committee expects to address throughout the year and the frequency with which it expects to address them. While drawn from the audit committee charter, the responsibilities included in a calendar/checklist typically provide additional detail beyond that included in the charter, including in some instances, best-practices recommendations. The Calendar and Checklist can be used to plan the number of audit committee meetings suitable for the user's purposes and to compile the agendas for each meeting. At the same time, it also serves as a checklist to ensure that the duties and responsibilities set forth in the audit committee's charter will be covered at the committee meetings scheduled throughout the year.

It has become accepted practice for audit committees to meet separately, in executive session, with the head of internal audit and with the external auditors.ⁿ⁹⁰ Indeed, audit committees of NYSE-listed companies are required to "meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors" and to "review with the independent auditor any audit problems or difficulties and management's response."ⁿ⁹¹ In addition, the ABA Task Force on Corporate Responsibility recommends that the general counsel meet separately in executive session with outside directorsⁿ⁹² and, for many companies, the audit committee meeting may be a logical forum for such executive sessions.ⁿ⁹³

[c] Time Commitment and Audit Committee Compensation

With the requirements added (in some cases) and clarified and made explicit (in other cases) by the corporate

governance reforms of 2003 (including the SEC rules relating to audit committees and the SRO corporate governance listing requirements), it is clearer than ever that, to discharge their duties properly, audit committee members must make a significant time commitment.ⁿ⁹⁴ The NYSE cautions that, "[b]ecause of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment."ⁿ⁹⁵

The NYSE endorsed the payment of "additional directors' fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members" ⁿ⁹⁶ Since the new audit committee requirements came into effect, audit committee meeting fees have risen considerably, and now tend to be significantly higher than fees for other board committee meetings.ⁿ⁹⁷

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses Business Judgment Rule Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion Business & Corporate Law Corporations Governing Documents & Procedures Records & Inspection Rights Recordkeeping Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act Securities Law Self-Regulating Entities National Association of Securities Dealers

FOOTNOTES:

(n1)Footnote 1. *See § 4.03 above*, discussing also the duty of oversight.

(n2)Footnote 2. *17 CFR § 240.10A-3(b)(2)* ("The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.").

(n3)Footnote 3. *17 CFR § 229.407(d)(3)(i)(C)*.

(n4)Footnote 4. Effective September 30, 2008, PCAOB Rule 3526 superseded. Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees.

(n5)Footnote 5. NYSE Listed Company Manual § 303A.07(c)(iii)(A).

(n6)Footnote 6. NYSE Listed Company Manual § 303A.07(c)(iii)(B).

(n7)Footnote 7. Nasdaq Rule 5605(c)(1)(C).

(n8)Footnote 8. *17 CFR § 229.407(d)(3)(i)(A)*.

(n9)Footnote 9. *See Business Roundtable, Principles of Corporate Governance 19 (May 2002), available at <http://www.businessroundtable.org/pdf/704.pdf> and reproduced in Appendix A to this treatise ("[T]he audit committee should provide a channel of communication to the board for the outside auditor and internal auditors"); The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 3 Audit and Accounting, Principle III, Specific Best Practice Suggestion No. 3, at 39 (Jan. 9, 2003) ("The internal auditor should have a direct line of communication and reporting responsibility to the audit committee, and he or she should attend all regularly scheduled audit committee meetings ... and meet with the audit committee in executive session.").*

(n10)Footnote 10. *See, e.g.*, Sarbanes-Oxley § 204, adding Section 10A(k) to the 1934 Act, 15 U.S.C. § 78j-1; 17 CFR § 210.2-07; NYSE Listed Company Manual § 303A.07(c)(iii)(B); AICPA, Statement on Auditing Standards Nos. 61, 90. These rules are discussed in detail in § 9.04[2][a][iv] below.

(n11)Footnote 11. Even before the advent of the new certification requirements under Sarbanes-Oxley, directors who signed materially false or misleading SEC filings on which investors relied were liable under Section 10(b) of the 1934 Act and *Rule 10b-5* thereunder. *See, e.g.*, Howard v. Everex Systems, Inc., 228 F.3d 1057, 1061 (9th Cir. 2000) (citing *AUSA Life Ins. Co. v. Dwyer*, 928 F. Supp. 1239 (S.D.N.Y. 1996) for the proposition that a director, acting with the requisite level of scienter, who signs a fraudulent Form 10-K can be liable as a primary violator of Section 10(b) of the 1934 Act for making a false statement; reasonable reliance on others with primary responsibility for reviewing and ensuring the integrity of the financial statements could make it more difficult for a plaintiff to establish scienter on the part of directors who signed the Annual Report on Form 10-K).

(n12)Footnote 12. 17 CFR § 210.2-07. This rule does not apply to Asset-Backed Issuers, as defined in 17 CFR §§ 240.13a-14(g) and 240.15d-14(g), or investment companies registered under Section 8 of the Investment Company Act of 1940, 15 U.S.C. § 80a-8, other than a unit investment trust as defined by Section 4(2) of the Investment Company Act of 1940, 15 U.S.C. § 80a-4(2).

(n13)Footnote 13. Auditing Standards Board, AICPA, Statement on Auditing Standards No. 114, The Auditor's Communication with Those Charged with Governance (superseding Statement on Auditing Standards 61).

(n14)Footnote 14. 17 CFR § 229.407(d)(3)(B). Note that, as of the date of this writing, this section of the regulations has not been updated to reflect the replacement of Statement on Auditing Standards 61 with Statement on Auditing Standards 114, but must now be interpreted to refer to the latter.

(n15)Footnote 15. When, at the end of 2006, to follow newly emerging international standards, the AICPA replaced Statement on Auditing Standards 61 with SAS 114, it changed the required recipient of such communications from the audit committee to "those charged with governance." For a U.S. public company, of which the board audit committee must be comprised entirely of independent directors, "those charged with governance" for purposes of the SAS 114 communications will normally remain the board audit committee.

(n16)Footnote 16. Sarbanes-Oxley Act § 404(a), 15 U.S.C. § 7262(a); SEC Release Nos. 33-8238, 34-47986, "Management Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" (June 5, 2003). Sarbanes-Oxley § 404 and related implementing regulations are reproduced in Appendix E to this treatise.

(n17)Footnote 17. Sarbanes-Oxley Act § 404(b), 15 U.S.C. § 7262(b); SEC Release Nos. 33-8238, 34-47986, "Management Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" (June 5, 2003).

(n18)Footnote 18. SEC Release Nos. 33-8238, 34-47986, "Management Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" (June 5, 2003) at § V(B).

(n19)Footnote 19. 17 CFR §§ 240.13a-14, 240.13a-15. Sarbanes-Oxley § 302 and related implementing regulations are reproduced in Appendix E to this treatise.

(n20)Footnote 20. 17 CFR § 240.13a-15(e).

(n21)Footnote 21. *See* NYSE Listed Company Manual § 303A.07(c)(ii).

(n22)Footnote 22. The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 3 Audit and Accounting, Principle I, Specific Best Practice Suggestion No. 4, at 37 (Jan. 9,

2003).

(n23)Footnote 23. *See § 6.02[8][a] and § 7.04 above* . A sample questionnaire for such a process is reproduced in Appendix 6-B to Chapter 6 *above* .

(n24)Footnote 24. *17 CFR § 210.10-01(d) (1999)*. If, in any filing, the company states that interim financial statements have been reviewed by an independent public accountant, a report of the accountant on the review must be filed with the interim financial statements.

(n25)Footnote 25. Auditing Standards Board, AICPA, Statement on Auditing Standards No. 100 (Nov. 2002).

(n26)Footnote 26. NYSE Listed Company Manual § 303A.07(c)(iii)(B).

(n27)Footnote 27. SAS 100, PP 29-30. This circumstance may also be reported to "others with equivalent authority and responsibility."

(n28)Footnote 28. SAS 100, PP 29-30. This circumstance may also be reported to "others with equivalent authority and responsibility."

(n29)Footnote 29. SAS 100, P 32.

(n30)Footnote 30. SAS 100, P 32.

(n31)Footnote 31. SAS 100, P 33.

(n32)Footnote 32. SAS 100, P 34. For a detailed discussion of the SAS 114 discussion items, *see § 9.04[2][a][iv] above*.

(n33)Footnote 33. *See 1934 Act Section 10A, 15 U.S.C. § 78j-1(i), added by Sarbanes-Oxley Act § 202; 17 CFR § 210.2-01(c)(7) (2003)*.

(n34)Footnote 34. *17 CFR § 210.2-01(c)(7)(i)(A)-(C)*.

(n35)Footnote 35. Sarbanes-Oxley and the regulations thereunder include a specific list of non-audit services that an outside accountant may not provide to the issuer and still remain independent. These are:

(i) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(ii) financial information systems design and implementation;

(iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(iv) actuarial services (unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements);

(v) internal audit outsourcing services;

(vi) management functions (including acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client);

(vii) human resources services (including recruiting, testing, reference-checking, negotiating terms or conditions of employment and recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions);

(viii) broker-dealer, investment adviser, or investment banking services;

(ix) legal services; and

(x) expert services unrelated to the audit (such as expert witnessing).

17 CFR § 210.2-01(c)(4).

(n36)Footnote 36. Sarbanes-Oxley Act § 202, adding 1934 Act § 10A(i)(3), 15 U.S.C. § 78-j-1(i)(3).

(n37)Footnote 37. *17 CFR § 210.2-01(c)(7)(i)(C)(2).*

(n38)Footnote 38. *17 CFR § 210.2-01(c)(7)(i)(C)(1)*, (3). The non-audit engagements of the independent accountants for a registered investment company must be pre-approved not only by its audit committee but also by the registered investment company's investment adviser (not including a sub-adviser whose role is primarily portfolio management and is sub-contracted or overseen by another investment adviser) and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing audit or non-audit services to the registered investment company, if the engagement relates directly to the operations and financial reporting of the registered investment company. In connection with such an engagement, the *de minimis* exception to the pre-approval requirement applies only if, during the fiscal year in which the services are provided, the payments for all services provided amount to no more than five percent of the total payments to the registered investment company's accountant by the registered investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company that would have to be pre-approved by the registered investment company's audit committee pursuant to *17 CFR § 210.2-01* (and only if the engagement meets the other two requirements of the *de minimis* exception, as well). *17 CFR § 210.2-01(c)(7)(ii).*

(n39)Footnote 39. PCAOB Rule 3524, "Audit Committee Pre-Approval of Certain Tax Services," available at http://www.pcaobus.org/Rules/Rules_of_the_Board/index.aspx. For audit committees that pre-approve non-audit services pursuant to policies and procedures, this rule does not apply to any such tax service commenced on or before April 19, 2007. See Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules, SEC Release 34-53677, April 19, 2006, available at <http://www.sec.gov/rules/pcaob.shtml>, at pp. 10-11.

(n40)Footnote 40. SEC Release Nos. 33-8732A, 34-54302A, "Executive Compensation and Related Person Disclosure," *71 Fed. Reg. 53158 (Sept. 8, 2006)*.

(n41)Footnote 41. *17 CFR § 229.404(b).*

(n42)Footnote 42. For example, under Delaware law, no contract or transaction with an officer, director or entity in which any such person is an officer or director or has a financial interest is void or voidable solely because (a) of that relationship, (b) that person participated in a board or committee meeting in which the contract or transaction was approved, or (c) that person's vote was counted in connection with that approval, if the material terms of that person's interest in the contract or transaction were fully disclosed to and the transaction or contract was approved in good faith

by the board of directors or a committee of the board by the affirmative votes of a majority of disinterested directors. Del. Gen. Corp. L. § 144(a).

(n43)Footnote 43. NYSE Listed Company Manual § 303A.07(c)(iii)(C) and NYSE commentary thereon.

(n44)Footnote 44. *17 CFR § 240.10A-3(b)(3)*. This regulation incorporates verbatim the language of Sarbanes-Oxley Act § 301, adding Section 10(A) to the 1934 Act, *15 U.S.C. § 78f(m)(4)*.

(n45)Footnote 45. See NYSE Listed Company Manual § 303A.03 and accompanying commentary.

(n46)Footnote 46. See *United States v. Upjohn*, 449 U.S. 383, 101 S. Ct. 677, 66 L. Ed. 2d 584 (1981); see generally, Chad R. Brown, *In-House Counsel Responsibilities in the Post-Enron Environment*, 21 ACCA Docket at 92, 101-105 (May 2003).

(n47)Footnote 47. Sarbanes-Oxley Act § 806, adding Section 1514A to title 18 of the United States Code.

(n48)Footnote 48. *17 CFR § 240.10A-3(b)(4)*.

(n49)Footnote 49. *17 CFR § 240.10A-3(b)(5)*.

(n50)Footnote 50. See also ABA Task Force Corporate Responsibility Report, Recommended Corporate Governance Policy IV.9., at 33, *59 Bus. Law. 145, 161 (2003)* ("Engagements of counsel by the board of directors, or by a committee of the board, for special investigations or independent advice should be structured to assure independence and direct reporting to the board of directors or the committee.").

(n51)Footnote 51. See § 9.04[2][f] above for discussion of consulting with counsel on the effect of privilege and confidentiality issues on assignments of investigations to various parties.

(n52)Footnote 52. *17 CFR § 240.13a-14(a)*; *17 CFR § 229.601(a), (b)(31)*, item 5.

(n53)Footnote 53. NYSE Listed Company Manual § 303A.07(c)(i)(A); see also Business Roundtable, Principles of Corporate Governance 18 (May 2002), available at <http://www.businessroundtable.org/pdf/704.pdf> and reproduced in Appendix A to this treatise ("Unless the full board or another committee does so, the audit committee should review the corporation's procedures addressing compliance with the law and important corporate policies, including the corporation's code of ethics or code of conduct.").

(n54)Footnote 54. But see § 13.02[2][b][iii] below for discussion of federal sentencing guidelines definition of an effective compliance program.

(n55)Footnote 55. See ABA Task Force Corporate Responsibility Report, Recommended Corporate Governance Practice VI.9., at 70-71, *59 Bus. Law. 145, 184-85 (2003)* ("The board of directors should charge a committee composed exclusively of independent directors (such as an audit committee or a legal compliance committee) with responsibility to obtain and evaluate regular reports from the corporate officers responsible for implementing the corporation's internal controls, codes of ethics and compliance policies, including general counsel, the chief financial officer, the chief internal auditor and the chief compliance officer, on legal and compliance affairs of the corporation, including, at a minimum, information about violations or potential violations of law and breaches of fiduciary duty by an executive officer or director that could have a material adverse effect on the corporation."); see also Business Roundtable, Principles of Corporate Governance 19 (May 2002) ("[T]he audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers and the general counsel."); The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 3 Audit and Accounting, Principle III, Specific Best Practice Suggestion No. 3, at 39 (Jan. 9, 2003) ("The internal auditor should have a direct line of communication and

reporting responsibility to the audit committee, and he or she should attend all regularly scheduled audit committee meetings ... and meet with the audit committee in executive session.").

(n56)Footnote 56. *See* § 13.02[2][c] below for discussion of the *Caremark* decision, which considered the responsibility of directors with respect to the oversight of legal and regulatory compliance systems.

(n57)Footnote 57. *See, e.g.,* ABA Task Force Corporate Responsibility Report, Recommended Corporate Governance Policy IV.7.b., at 32, *59 Bus. Law. 145, 161 (2003)* (recommending that public company boards provide for regular meetings in executive session of a committee of independent directors and the general counsel "to communicate concerns regarding legal compliance matters, including potential or ongoing material violations of law by, and breaches of fiduciary duty to, the corporation"). While the ABA Task Force recommendation does not specify that the committee of independent directors that meets with the general counsel in executive session must be the audit committee, that would be a sensible allocation of responsibility, in view of the audit committee's responsibility to assist with board oversight of compliance with legal and regulatory requirements. *See also* ABA Task Force Corporate Responsibility Report, Recommended Corporate Governance Practice VI.9., at 70-71, *59 Bus. Law. 145, 184-85 (2003)* ("The board of directors should charge a committee composed exclusively of independent directors (such as an audit committee or a legal compliance committee) with responsibility to obtain and evaluate regular reports from the corporate officers responsible for implementing the corporation's internal controls, codes of ethics and compliance policies, including general counsel ...").

(n58)Footnote 58. *See* § 14.07[3] below, discussing the attorney-conduct rules at greater length.

(n59)Footnote 59. "Appearing and practicing before the Commission" includes: transacting any business with the Commission, including communications in any form; representing an issuer in an SEC administrative proceeding or in connection with an SEC investigation, inquiry, information request, or subpoena; providing advice on U.S. securities laws or SEC rules and regulations regarding documents that the attorney has notice will be filed, submitted or incorporated by reference into a filing with the SEC; or advising an issuer regarding whether information or a statement, opinion or other writing is required under U.S. securities laws or SEC rules and regulations. *17 CFR § 205.2*.

(n60)Footnote 60. "Evidence of a material violation" means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur; this includes material violations of federal or state securities laws, a material breach of fiduciary duty arising under U.S. federal or state law, or a similar material violation of any federal or state law. *17 CFR § 205.2*.

(n61)Footnote 61. *17 CFR § 205.3*.

(n62)Footnote 62. Very few companies, however, have designated the audit committee as a QLCC.

(n63)Footnote 63. The QLCC must have adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under the new rules. In addition, the committee must have been duly established by the board of directors, with the authority and responsibility: (i) to inform the issuer's CLO and CEO of any report of evidence of a material violation; (ii) to determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, (iii) if it determines an investigation is necessary or appropriate, to pursue any of the following courses of action:

- notifying the audit committee or the full board of directors;
- initiating an investigation, which may be conducted either by the CLO (or the equivalent thereof) or by outside attorneys;

- retaining such additional expert personnel as the committee deems necessary.

The QLCC must also be authorized, at the conclusion of any such investigation, to

- recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and
- inform the CLO and the CEO and the board of directors of the results of any investigation and the appropriate remedial measures to be adopted.

Finally, the QLCC must have the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the SEC in the event that the issuer fails in any material respect to implement an appropriate response that the QLCC has recommended to the issuer. *17 CFR § 205.2(k)*.

(n64)Footnote 64. NYSE Listed Company Manual, § 303A.07(c)(iii)(D).

(n65)Footnote 65. NYSE Listed Company Manual, § 303A.07(c)(iii)(D) Commentary. *See also* Business Roundtable, Principles of Corporate Governance 16-17 (November 2005) ("The audit committee should understand the corporation's business and risk profile and apply their business experience and judgment with an independent and critical eye"); The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 3 Audit and Accounting, Principle III, Specific Best Practice Suggestions Nos. 2 and 4, at 33 (Jan. 9, 2003) ("The internal auditor should prepare for review and approval by the audit committee a multi- year audit plan of not less than three years, centered on the corporation's risks and vulnerabilities The Commission believes that every public company board, and especially the audit committee, should make enterprise risk assessment and internal controls high priorities").

(n66)Footnote 66. *See, Find Lessons in Enron*, Business Insurance, Vol. 36, No. 13, at 8 (April 1, 2002).

(n67)Footnote 67. *17 CFR § 240.14a-101*, Item 7.

(n68)Footnote 68. *17 CFR §§ 229.407(d)(4)* and *407(b)(3)*.

(n69)Footnote 69. *17 CFR §§ 229.407(d)(4)* and *407(d)(3)*.

(n70)Footnote 70. *17 CFR §§ 229.407(a)* and *407(d)(2)*.

(n71)Footnote 71. *17 CFR § 229.407(d)(5)(i)(A)*.

(n72)Footnote 72. *17 CFR § 229.407(d)(5)(i)(B)* and *(C)* (2009). For a detailed definition of "financial expert," *see § 9.03[2][a]*, above.

(n73)Footnote 73. *17 CFR § 229.407(d)(3)(i)*.

(n74)Footnote 74. For a detailed discussion of SAS 61, *see § 9.04[2][a][iv]* above.

(n75)Footnote 75. *17 CFR § 229.407(d)(3)(ii)*.

(n76)Footnote 76. *15 U.S.C. § 80a-1 et seq.*

(n77)Footnote 77. *17 CFR § 240.14a-101*, Item 7(e).

(n78)Footnote 78. *17 CFR § 240.14a-101*, Item 9(e)(1). Schedule 14A Item 9 is reproduced in Appendix D to this treatise.

(n79)Footnote 79. *17 CFR § 240.14a-101*, Item 9(e)(2).

(n80)Footnote 80. *17 CFR § 240.14a-101*, Item 9(e)(3).

(n81)Footnote 81. *17 CFR § 240.14a-101*, Item 9(e)(4).

(n82)Footnote 82. *17 CFR § 240.14a-101*, Item 9(e)(5)(i).

(n83)Footnote 83. *17 CFR § 240.14a-101*, Item 9(e)(5)(ii).

(n84)Footnote 84. *17 CFR § 240.14a-101*, Item 9(e)(6).

(n85)Footnote 85. *17 CFR § 240.14a-101*, Item 9(e)(7).

(n86)Footnote 86. *17 CFR § 240.14a-101*, Item 9(e)(8).

(n87)Footnote 87. Form 10-K, General Instructions, Item 14(5).

(n88)Footnote 88. *See, e.g.,* The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 3 Audit and Accounting, Principle II: Audit Committee Education at 37 (Jan. 9, 2003).

(n89)Footnote 89. *See* Business Roundtable, Principles of Corporate Governance 20 (November 2005) ("Audit committee meetings should be held frequently enough to allow the committee to monitor the corporation's financial reporting appropriately.").

(n90)Footnote 90. *See* Business Roundtable, Principles of Corporate Governance 20 (November 2005) ("Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet privately with each of the internal and outside auditors and management on a regular basis, and in any event at least quarterly, and communicate with them between meetings as necessary.").

(n91)Footnote 91. NYSE Listed Company Manual § 303A.07(c)(iii)(E), (F).

(n92)Footnote 92. ABA Task Force Corporate Responsibility Report, Recommended Corporate Governance Policy IV.7.b., at 32, *59 Bus. Law. 145, 161 (2003)*.

(n93)Footnote 93. *See* Business Roundtable, Principles of Corporate Governance 19 (May 2002) ("[T]he audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers and the general counsel.").

(n94)Footnote 94. *See* The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 3 Audit and Accounting, at 30 (Jan. 9, 2003) ("Boards should not underestimate the requirements of the [Sarbanes-Oxley] Act and of the proposed New York Stock Exchange listing requirements with respect to audit committees and should devote sufficient resources and time to implement their requirements.").

(n95)Footnote 95. NYSE Listed Company Manual § 303A.07(a) Commentary. *See also* § 9.03[2][c] above for discussion of the NYSE's rule regarding service on no more than three audit committees.

(n96)Footnote 96. SEC Release No. 34-47672, File No. SR-NYSE-2002-33 (Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance),

adding section 303A to NYSE Listed Company Manual, P 6, Commentary.

(n97)Footnote 97. *See, e.g.*, Spencer Stuart U.S. Board Index 2008, at 33, available at http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf (reporting that the average meeting fee paid to audit committee members is 53 percent higher than meeting fees paid to members of other committees); Press Release, Hewitt Associates, LLC, "Companies Make Changes to U.S. Board Compensation in 2003, Hewitt Study Shows," (May 2, 2003)(on file with author).



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Appendix 9-A: Sample Audit Committee Charter for New York Stock Exchange Company

1-9-A Corporate Governance: Law and Practice Appendix 9-A:.syn

§ 9-A.syn Synopsis to Appendix 9-A: Sample Audit Committee Charter for New York Stock Exchange Company

[9-A] Sample Audit Committee Charter for New York Stock Exchange Company



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Appendix 9-A: Sample Audit Committee Charter for New York Stock Exchange Company

1-9-A Corporate Governance: Law and Practice [9-A]

[9-A] Sample Audit Committee Charter for New York Stock Exchange Company

AUDIT COMMITTEE CHARTER

[Note: This is a comprehensive draft that is intended to include all duties and responsibilities that best practices dictate.]

1. *Members.* The Board of Directors appoints an Audit Committee of at least three members, consisting entirely of independent directors and designates one member as chairperson or delegates the authority to designate a chairperson to the Audit Committee. Members of the Audit Committee are appointed by the Board of Directors upon the recommendation of the Nominating and Corporate Governance Committee. For purposes hereof, the term "independent" shall mean a director who meets the New York Stock Exchange ("NYSE") standards of independence for directors and audit committee members, as determined by the Board.

Each member of the Audit Committee must be financially literate, as determined by the Board. [In addition, at least one member of the Committee must be an "audit committee financial expert," as determined by the Board in accordance with Securities and Exchange Commission ("SEC") rules]. **OR** [In addition, at least one member of the Committee must have accounting or related financial management expertise, as determined by the Board].

2. *Purpose, Duties, and Responsibilities.*

The purpose of the Audit Committee, at a minimum, must be to:

- represent and assist the Board of Directors in discharging its oversight responsibility relating to: (i) the accounting, reporting, and financial practices of the Company and its subsidiaries, including the integrity of the Company's financial statements; (ii) the surveillance of administration and financial controls and the Company's compliance with legal and regulatory requirements; (iii) the outside auditor's qualifications and independence; and (iv) the performance of the Company's internal audit function and the Company's outside auditor; and
- prepare the report required by the rules of the SEC to be included in the Company's annual proxy statement.

Among its specific duties and responsibilities, the Audit Committee shall:

(i) Be directly responsible, in its capacity as a committee of the Board, for the appointment, compensation, retention and oversight of the work of the outside auditor. In this regard, the Audit Committee shall appoint and retain, [subject to ratification by the Company's stockholders], compensate, evaluate, and terminate, when appropriate, the outside auditor, which shall report directly to the Audit Committee.

(ii) Obtain and review, at least annually, a report by the outside auditor describing: (A) the outside auditor's internal quality-control procedures; and (B) any material issues raised by the most recent internal quality-control review, or peer review, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the outside auditor, and any steps taken to deal with any such issues.

(iii) Approve in advance all audit and permissible non-audit services to be provided by the outside auditor, and establish policies and procedures for the pre-approval of audit and permissible non-audit services to be provided by the outside auditor.

(iv) Consider, at least annually, the independence of the outside auditor, including whether the outside auditor's performance of permissible non-audit services is compatible with the auditor's independence, and obtain and review a report by the outside auditor describing any relationships between the outside auditor and the Company and any other relationships that may adversely affect the independence of the auditor.

(v) Review and discuss with the outside auditor: (A) the scope of the audit, the results of the annual audit examination by the auditor, and any problems or difficulties the auditor encountered in the course of its audit work and management's response; and (B) any reports of the outside auditor with respect to interim periods.

(vi) Review and discuss with management and the outside auditor the annual audited and quarterly financial statements of the Company, including: (A) an analysis of the auditor's judgment as to the quality of the Company's accounting principles, setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements; (B) the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations," including accounting policies that may be regarded as critical; and (C) major issues regarding the Company's accounting principles and financial statement presentations, including any significant changes in the Company's selection or application of accounting principles and financial statement presentations.

(vii) Recommend to the Board based on the review and discussion described in paragraphs (iv) - (vi) above, whether the financial statements should be included in the Annual Report on Form 10-K.

(viii) Receive reports from the outside auditor and management regarding, and review and discuss the adequacy and effectiveness of, the Company's internal controls, including any significant deficiencies in internal controls and significant changes in internal controls reported to the Audit Committee by the outside auditor or management.

(ix) Receive reports from management regarding, and review and discuss the adequacy and effectiveness of, the Company's disclosure controls and procedures.

(x) Review and discuss with the principal internal auditor of the Company the scope and results of

the internal audit program.

(xi) Review and discuss earnings press releases, and corporate practices with respect to earnings press releases and financial information and earnings guidance provided to analysts and ratings agencies.

(xii) Review and discuss the Company's practices with respect to risk assessment and risk management.

(xiii) Oversee the Company's compliance systems with respect to legal and regulatory requirements and review the Company's codes of conduct and programs to monitor compliance with such codes.

(xiv) Establish procedures for handling complaints regarding accounting, internal accounting controls and auditing matters, including procedures for confidential, anonymous submission of concerns by employees regarding accounting and auditing matters.

(xv) Establish policies for the hiring of employees and former employees of the outside auditor.

(xvi) Annually evaluate the performance of the Audit Committee and assess the adequacy of the Audit Committee charter.

3. *Outside Advisors.* The Audit Committee shall have the authority to retain such outside counsel, accountants, experts and other advisors as it determines appropriate to assist it in the performance of its functions and shall receive appropriate funding, as determined by the Audit Committee, from the Company for payment of compensation to any such advisors.

4. *Meetings.* The Audit Committee shall meet at least four times per year, either in person or telephonically, and at such times and places as the Audit Committee shall determine. The Audit Committee shall meet separately in executive session, periodically, with each of management, the principal internal auditor of the Company, [and] the outside auditor [and the general counsel]. The Audit Committee shall report regularly to the full Board of Directors with respect to its activities. The majority of the members of the Audit Committee shall constitute a quorum.



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Appendix 9-B: Sample Audit Committee Responsibilities Calendar and Checklist

1-9-B Corporate Governance: Law and Practice Appendix 9-B:.syn

§ 9-B.syn Synopsis to Appendix 9-B: Sample Audit Committee Responsibilities Calendar and Checklist

[9-B] Sample Audit Committee Responsibilities Calendar and Checklist



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Appendix 9-B: Sample Audit Committee Responsibilities Calendar and Checklist

*1-9-B Corporate Governance: Law and Practice [9-B]***[9-B] Sample Audit Committee Responsibilities Calendar and Checklist**

Responsibility	Annually	Quarterly	Periodically	As needed
Financial Reporting				
1. Review and discuss financial statements, including MD&A	X			
2. Discuss the outside auditor's judgment about the quality of the Company's accounting principles and other matters required under SAS Nos. 61 and 100 (annual audited financial statements), and SAS No. 71 (interim financial statements)	X			
3. Receive report from the outside auditor regarding critical accounting policies, alternative treatments of financial information that have been discussed with management, and other material written communications between the outside auditor and management	X			
4. Review and discuss with the outside auditor the results of the annual audit examination, and any audit problems or difficulties encountered and management's response	X			
5. Recommend to the Board whether the annual audited financial statements should be included in the 10-K	X			

- | | | |
|--|---|---|
| 6. Review earnings releases | X | |
| 7. Review and discuss policies regarding earnings press releases, and financial information and earnings guidance provided to analysts and rating agencies | X | X |

Outside Auditor

- | | | |
|--|---|---|
| 8. Review the qualifications of the outside auditor, including performance and independence, and review report on: (a) quality-control procedures, peer reviews and investigations within prior five years and steps taken to respond to any issues raised by the reviews, and (b) all relationships between the outside auditor and the Company | X | |
| 9. Approve engagement of the outside auditor and terms of engagement | X | |
| 10. Review pre-approval policy and pre-approve audit services (in addition to the annual audit) and permissible non-audit services expected to be provided by the outside auditor | X | X |
| 11. Meet in executive sessions with the outside auditor | X | |
| 12. Receive report on: (a) services provided by and fees paid to the outside auditor during the previous quarter and current fiscal year; and (b) pre-approvals of audit and permissible non-audit services made by one or more Audit Committee members pursuant to delegated authority | X | |
| 13. Review policies regarding hiring of employees and former employees of outside auditor | X | |

Internal Control

- | | | |
|--|---|--|
| 14. Discuss with management, internal audit and the outside auditor the adequacy and effectiveness of internal controls and disclosure controls and procedures | X | |
|--|---|--|

1-9-B Corporate Governance: Law and Practice [9-B]

15. Receive report from CEO and CFO on any significant deficiencies in the design or operation of internal controls, and any fraud involving management or other employees who have a significant role in internal controls	X	
16. Review risk assessment and risk management policies	X	X
17. Review Code of Business Conduct and Ethics and compliance with code	X	X
18. Review procedures related to the receipt, retention and treatment of complaints regarding accounting, internal accounting controls, and auditing matters	X	
19. Receive report on complaints regarding accounting, internal accounting controls, and auditing matters	X	X
Internal Audit		
20. Review internal audit plan, including scope and performance of internal audit function	X	
21. Review status of current internal audit plan and significant findings	X	X
22. Meet in executive session with internal audit	X	
Committee Matters		
23. Review minutes of previous meeting	X	
24. Complete "audit committee financial expert" questionnaire for Board determination regarding whether the Audit Committee has an audit committee financial expert	X	
25. Review Audit Committee report and related proxy information	X	
26. Meet in executive session with management	X	
27. Report to full Board	X	X
28. Conduct performance evaluation and review and assess the adequacy of the charter	X	



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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice 10.syn

AUTHOR: Bart SchwartzAmy GoodmanSean Feller

§ 10.syn Synopsis to Chapter 10: THE COMPENSATION COMMITTEE *

§ 10.01 Rise of the Compensation Committee

§ 10.02 Nature of Legal Requirements for Board Compensation Committees

§ 10.03 Scrutiny of Compensation Committee Proceedings

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[ii] Criteria for Performance Goals

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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice § 10.01

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§ 10.01 Rise of the Compensation Committee

The role of board compensation committees has featured in reported cases concerning the propriety of corporate transactions at least since the early 1960s.ⁿ¹ Throughout the 1970s and 1980s, compensation committee issues were repeatedly litigated in shareholder derivative actions and other lawsuits claiming waste of corporate assets, management entrenchment, securities law violations and breaches of fiduciary duties.ⁿ²

In the early 1990s, the role of the compensation committee took on added and more formal legal significance, largely as a result of two developments:

- the adoption in 1992 of federal securities regulations requiring new proxy statement disclosures about executive compensation and the compensation committee;ⁿ³ and
- the enactment in 1993 of *Section 162(m) of the Internal Revenue Code* ("IRC"), eliminating the corporate income tax deduction for compensation over \$1 million paid to the chief executive officer and the other four most highly compensated executive officers whose compensation is required to be disclosed under the Securities Exchange Act of 1934 (the "1934 Act" or the "Exchange Act"), with certain important exceptions.

The first set of these regulations dealt with disclosure obligations and made the work of the compensation committee highly visible to the investing public (and others); the second set--dealing with tax deductibility to the employer of certain executive compensation--had considerable substantive significance for the composition and proceedings of compensation committees, as discussed *below*.

In 2003, the composition and proceedings of the compensation committee became the subject of new corporate governance listing standards of the New York Stock Exchange (the "NYSE"), the NYSE Amex (previously the American Stock Exchange (the "Amex") and the NASDAQ Stock Market (the "NASDAQ" and collectively with the NYSE and the Amex, the "SROs"), and of new best practice guidelines published by a number of influential organizations. Starting the same year, the work of the compensation committee came under intense public and judicial scrutiny in several highly publicized cases.

In 2006, the SEC adopted comprehensive new regulations prescribing extensive and detailed requirements for the disclosure not only of executive compensation and related-party transactions but of the processes of board compensation committees and of companies' procedures for approval of related-party transactions.ⁿ⁴

In October 2008, the U.S. government passed the Emergency Economic Stabilization Act of 2008 ("EESA") and the Troubled Asset Relief Program ("TARP") thereunder (Public Law No: 110-343), and in February 2009, the U.S. government passed the American Recovery and Reinvestment Act of 2009 (Public Law No: 111-5) ("ARRA," and together with EESA, TARP, and the guidance issued in connection therewith, the "Stimulus Programs") as a part of the government's efforts to address the U.S financial crisis. The Stimulus Programs impose new requirements on the compensation committees of participating companies.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Causes of Action General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Proxies General Overview Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges American Stock Exchange Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange Tax Law Federal Income Tax Computation Deductions for Business Expenses Business, Entertainment & Trade Expenses (IRC secs. 162, 274)

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Dann v. Chrysler Corp., 41 Del. Ch. 438, 198 A.2d 185, 196 (Del. Ch. 1963)* (interested director's membership on compensation committee allegedly a source of undue influence over other directors in connection with their approval of contested transactions).

(n2)Footnote 2. *See, e.g., International Ins. Co. v. Johns, 874 F.2d 1447, 1464 (11th Cir. 1989)* (implementation of compensation plan for defendant directors in anticipation of a merger was protected under the business judgment rule, in part because it was considered and approved by disinterested compensation committee); *Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (Cal. Ct. App., 1st Dist., 1989)* (in shareholder derivative suit claiming waste of corporate assets and breach of fiduciary duties in connection with the approval of "golden parachutes" on the eve of a merger, court was critical of role and proceedings of board compensation committee); *Mills v. Esmark, Inc., 544 F. Supp. 1275, 1287 (N.D. Ill. 1982)* (decision on dismissal of derivative suit by special litigation committee where the underlying allegations involved, among other things, allegedly inappropriate proceedings and decisions of the board compensation committee); *Cohen v. Ayers, 596 F.2d 733, 744-45 (7th Cir. 1979)* (in shareholder derivative suit challenging stock option repricing, plaintiff argued that compensation committee independence issues had not been fully disclosed); *SEC v. Potter Instrument Co., No. 77-0394, 1977 U.S. Dist. LEXIS 16981, *9 (D.D.C. Mar. 9, 1977)* (establishment of independent compensation committee was one of the elements of a consent decree arising out of an SEC enforcement action); *Nomad Acquisition Corp. v. Damon Corp., CA 10173, 1988 Del. Ch. LEXIS 133, *17 (Sept. 20, 1988)* (decisions of compensation committee relating to amendment of certain employee benefit plans were protected, under the business judgment rule, from attack where committee was comprised entirely of independent directors and plaintiffs had not established that committee members breached their duties of care or loyalty); *Freedman v. Barrow, 427 F. Supp. 1129, 1136 (S.D.N.Y. 1976)* (in derivative action challenging stock appreciation rights, court cited existence of independent board compensation committee in opinion rejecting plaintiffs' claims); *Michelson v. Duncan, 407 A.2d 211 (Del. 1979)* (derivative suit challenging independence of compensation committee and the committee's actions in modifying stock option plan and granting options under the modified plan).

(n3)Footnote 3. *17 CFR § 229.402(k)*, adopted in SEC Release Nos. 33-6962, 34-31327, *57 Fed. Reg. 48126 (Oct. 21, 1992)*.

(n4)Footnote 4. SEC Release Nos. 33-8732A, 34-54302A, "Executive Compensation and Related Person Disclosure," *71 Fed. Reg. 53158 (Sept. 8, 2006)* .

* The authors gratefully acknowledge the assistance of Dina Bernstein, an associate at Gibson, Dunn & Crutcher, with the updates to this chapter.



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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice § 10.02

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§ 10.02 Nature of Legal Requirements for Board Compensation Committees

As a result of the developments mentioned above, the stock exchange rules now provide specific structural and procedural requirements for board compensation committees of listed companies. In addition, partly as a result of corporate governance ratings and scores that became popular after the enactment of the Sarbanes-Oxley Act of 2002ⁿ¹ (the "Sarbanes-Oxley Act" or "Sarbanes-Oxley"), companies have become increasingly aware of and attuned to best-practices recommendations and guidelines for board compensation committees.

Post-Enron judicial decisions tend to reinforce the basic duties of board compensation committees, which are no different from the basic duties of other directors. Nevertheless, along with other developments described in this chapter, they also tend to make the work of compensation committees more visible than they had been in the past and they hold up "best practices" standards for such committees. The fundamental duties of loyalty and due care apply to board compensation committee members as they do to other directors, and the business judgment rule plays the same role in the defense of challenged actions of board compensation committees as it does in connection with other board decisions.ⁿ² Nevertheless, the scrutiny with which courts have examined issues of compensation committee independence and procedure has become more intense, resulting in increased pressures on board compensation committees and making good order and procedure for board compensation committees more important than ever before.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesBusiness Judgment RuleBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesFiduciary ResponsibilitiesGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley ActSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11 U.S.C., 15

U.S.C., 18 U.S.C., 28 U.S.C., 29 U.S.C.).

(n2)Footnote 2. *See* Chapter 4 *above* for discussion of the duties and responsibilities of the board.

* The authors gratefully acknowledge the assistance of Dina Bernstein, an associate at Gibson, Dunn & Crutcher, with the updates to this chapter.



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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice § 10.03

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§ 10.03 Scrutiny of Compensation Committee Proceedings

[1] Cases Focusing on Compensation Committee Proceedings

After the passage of Sarbanes-Oxley, influential jurists began to signal their intent to look more closely at the proceedings of board compensation committees. In a January 2003 panel discussion (moderated by Charles M. Elson, the head of the University of Delaware's Center for Corporate Governance), Delaware Chief Justice E. Norman Veasey presaged the coming shift in the approach of the Delaware courts generally in cases involving challenged actions of public company directors and specifically with regard to the proceedings of board compensation committees:

Elson: "One regulatory body that has existed forever is the courts. Should we be looking to the courts for guidance on these issues? Chief Justice Veasey "I do think the changes in corporate governance that we're seeing through the voluntary best practices codes, for example, or through the New York Stock Exchange listing requirements have created a new set of expectations for directors. And that is changing how courts look at these issues. In particular, I urge you to read our opinion in the Disney case, which ties in with some of the things that have been said here

... .

[I]f directors claim to be independent by saying, for example, that they base decisions on some performance measure and don't do so, or if they are disingenuous or dishonest about it, it seems to me that the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith. I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly presented complaint. Compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently."n1

Chief Justice Veasey was referring to a case challenging severance compensation paid to Michael Ovitz, the former president of the Walt Disney Company. Plaintiffs had brought a shareholders' derivative action for breach of fiduciary

duties, waste of corporate assets and other claims challenging the decisions of the board of directors of the Walt Disney Company (1) to approve the hiring of Michael Ovitz as president of the company under a contract providing severance terms that turned out to be extremely lucrative (as well as other terms and conditions that the plaintiffs criticized as being inimical to the company's best interests), and (2) later (after the board was reconstituted) to agree to a "no-fault" termination of Ovitz's employment, triggering total severance payments allegedly amounting to over \$140 million (including gains on stock options).

In the early stages of the litigation, the chancery court had granted defendants' motion to dismiss the shareholders' derivative complaint for lack of a pre-suit demand on the Disney board of directors, rejecting plaintiffs' argument of demand futility. Reviewing the ruling *de novo*, the Delaware Supreme Court (in a decision that will be referred to here as "*Disney I*") affirmed the dismissal in part but remanded the case to permit the plaintiffs to file an amended complaint. The Delaware Supreme Court took the opportunity to express its concerns about the merits of the challenged decisions and to criticize the proceedings of the Disney's board:

This is potentially a very troubling case on the merits. On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory From what we can ferret out of this deficient pleading, the processes of the Old Board and the New Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions

But our concerns about lavish executive compensation and our institutional aspirations that boards of directors of Delaware corporations live up to the highest standards of good corporate practices do not translate into a holding that these plaintiffs have set forth particularized facts excusing a pre-suit demand under our law and our pleading requirements.ⁿ²

The court explained that the gravamen of the claim that the Disney board had breached its duty of care, thereby excusing pre-suit demand, was the allegation that the board had failed to inform itself of material facts:

The Complaint ... alleges that the Old Board failed properly to inform itself about the total costs and incentives of the Ovitz Employment Agreement, especially the severance package. This is the key allegation related to this issue on appeal The Complaint alleges, however, that the Old Board had been advised by a corporate compensation expert, Graef Crystal, in connection with its decision to approve the Ovitz Employment Agreement

... One of the charging paragraphs of the Complaint concludes:

"57. As has been conceded by Graef Crystal, the executive compensation consultant who advised the Old Board with respect to the Ovitz Employment Agreement, the Old Board *never* considered the costs that would be incurred by Disney in the event Ovitz was terminated from the Company for a reason other than cause prior to the natural expiration of the Ovitz Employment Agreement."ⁿ³

Before addressing whether the well-pleaded allegations of the complaint overcame the presumptive protection of the business judgment rule, thereby excusing pre-suit demand, the Delaware Supreme Court was careful to distinguish (a) the board's apparent failure to follow good corporate governance practices, from (b) alleged breaches of directors' fiduciary duties:

This is a case about whether there should be personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decision-making process and for waste of

corporate assets. This case is not about the failure of the directors to establish and carry out ideal corporate governance practices.

All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.ⁿ⁴

Noting that the board was entitled to rely on the opinion of its compensation consultant that the contract was proper, despite his later after-the-fact criticism of the contract and of his own performance, the Delaware Supreme Court rejected the argument that the complaint sufficiently alleged that the Disney board had breached its duty of care by failing to inform itself of all reasonably available material facts.ⁿ⁵

More than three years later, on May 28, 2003 (in a decision that will be referred to here as "*Disney II*"), Chancellor Chandler ruled on a motion to dismiss the second amended complaint in the same case.ⁿ⁶ This time, on a more developed factual record, the court concluded that the allegations of the complaint were sufficient to withstand a motion to dismiss the derivative litigation. Some commentators, including this one, later argued that *Disney II* represented a decisive shift in the Delaware courts' approach.

In *Disney II*, if the allegations in the amended complaint had been sufficient to state a claim only for a breach of the directors' duty of care, the complaint could not have withstood a motion to dismiss, since the directors would have been entitled to the benefit of Disney's charter provision--adopted pursuant to Delaware General Corporation Law Section 102(b)(7)ⁿ⁷-- protecting them from liability for damages for breach of their duty of care. Nevertheless, the court found that the facts pleaded went beyond allegations of simple (or even gross) negligence and raised "cognizable questions whether the defendant directors ... should be held personally liable to the corporation for a knowing or intentional lack of due care in the company's decision- making process regarding Ovitz's employment and termination" The court went on to explain:

It is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors. But the facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary; plaintiffs' new complaint suggests that the Disney directors failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders.ⁿ⁸

Nevertheless, in August 2004, after a full trial on the merits, Chancellor Chandler held (in a decision that will be referred to here as "*Disney III*") that none of the defendant directors had breached his fiduciary duties or committed waste.ⁿ⁹ As the Delaware Supreme Court had done in *Disney I*, Chancellor Chandler distinguished between corporate governance "best practices" and legal duties:

As I will explain in painful detail hereafter, there are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance ...

Unlike ideals of corporate governance, a fiduciary's duties do not change over time ... This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not--indeed, the common law cannot--hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices, any more than a common-law court deciding a medical malpractice dispute can impose a standard of liability based on

ideal--rather than competent or standard--medical treatment practices, lest the average medical practitioner be found inevitably derelict.ⁿ¹⁰

Echoing *Disney II*, Chancellor Chandler further observed that "the concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith."ⁿ¹¹ However, analyzing separately the behavior of each of the key directors (those involved in the negotiation, review and approval of the Ovitz employment agreement and of the termination of Ovitz's employment, including the Chairman and other members of the Compensation Committee of the Disney Board of Directors), Chancellor Chandler found that, while none did a perfect job, each director had done at least the minimum required to satisfy his legal duties.

Particularly instructive for members of compensation committees is the court's distinction between the behavior of the board of directors of Trans Union Corporation in approving the merger at issue in the famous case of *Smith v. Van Gorkom*,ⁿ¹² on the one hand, and the behavior of certain members of the Compensation Committee of the Disney Board in the case before it, on the other hand. First, the court noted that the merger in *Van Gorkom* was "orders of magnitude more important ... than the transaction at issue here."ⁿ¹³

Second, the court contrasted the two hours that the Trans Union board had spent deliberating and discussing "this monumental transaction in the Life of Trans Union" with the time (less than one hour, which was the approximate length of the entire meeting) that the Disney Compensation Committee had spent on the Ovitz contract:

I am persuaded ... that the ... [Ovitz contract] was discussed for a not insignificant length of time. Is that length of time markedly less than the attention given by the Trans Union board to the merger agreement they were statutorily charged with approving or rejecting? Yes. Is that difference probative on the issue of whether the compensation committee adequately discussed the ... [Ovitz contract]? Not in the least. When the Trans Union board met for those two hours, it was the very first time any of those directors had discussed a sale of the company. Here, all the members of the committee were aware in advance that Ovitz's hiring would be discussed, and the members of the committee had also previously had more than minimal informal discussions amongst themselves as to the *bona fides* of the ... [Ovitz contract] before the meeting ever occurred. Furthermore, as mentioned above, the nature and scope of the transactions are fundamentally different.ⁿ¹⁴

Third, the court contrasted the complete absence of documentation before the Trans Union board in the *Van Gorkom* case with the term sheet that was put before the Disney Compensation Committee when it was asked to approve the Ovitz contract:

[T]he Trans Union board had absolutely no documentation before it when it considered the merger agreement. The board was completely reliant on the misleading and uninformed presentations given by Trans Union's officers (Van Gorkom and Romans). In contrast, the compensation committee was provided with a term sheet of the key terms of the ... [Ovitz contract] and a presentation was made by Russell [the chairman of Disney's Compensation Committee] (assisted by Watson [another member of the Compensation Committee and a past chairman of Disney's Board of Directors]), who had personal knowledge of the relevant information by virtue of his negotiations with Ovitz and discussions with Crystal [the committee's executive compensation consultant] ... It is true that the compensation committee did not review and discuss the then-existing draft of the full text of the ... [Ovitz contract]. This, however, is not required. Nor is it necessary for an expert to make a formal presentation at the committee meeting in order for the board to rely on that expert's analysis, although that certainly would have been the better course of action. Furthermore, the Company's compensation committee reasonably and wisely left the task of negotiating and drafting the actual text of the ... [Ovitz contract] in the hands of the Company's counsel.ⁿ¹⁵

Fourth, Chancellor Chandler noted that, in *Van Gorkom*, members of the company's senior management had opposed the merger at issue whereas, in the case before it, "the Company's senior management generally saw Ovitz's hiring as a boon for the Company ..."n16

On the subject of the Compensation Committee's reliance on the allegedly flawed analysis of the committee's executive compensation consultant, the court concluded that, despite the subsequent criticism of that analysis, "nothing in the record leads me to conclude that any member of the Compensation Committee had actual knowledge that would lead them to believe ... that Crystal's analysis was inaccurate or incomplete. Without that knowledge, I conclude the compensation committee acted in good faith and relied on Crystal in good faith, and that the fault for errors or omissions in Crystal's analysis must be laid at his feet, and not upon the compensation committee."n17

The court concluded this section of the analysis where it had begun--by distinguishing between corporate governance best practices, on the one hand, and the requirements of Delaware law, on the other hand:

Are there many aspects of Ovitz's hiring that reflect the absence of ideal corporate governance? Certainly, and I hope that this case will serve to inform stockholders, directors and officers of how the Company's fiduciaries underperformed. As I stated earlier, however, the standards used to measure the conduct of fiduciaries under Delaware law are not the same standards used in determining good corporate governance. For all the foregoing reasons, I conclude that none of the defendants breached their fiduciary duties or acted in anything other than good faith in connection with Ovitz's hiring, the approval of the ... [Ovitz contract], or his election to the Company's presidency.n18

The Delaware Supreme Court upheld the *Disney III* in a decision that will be referred to here as *Disney IV*.n19 Like the trial court, in *Disney IV* the Delaware Supreme Court distinguished between "best practices" and the minimum requirements for due care under the business judgment rule. While the Court observed, as had the trial court, that a better process would have provided the compensation committee with more neatly packaged information about the potential severance payments that Ovitz might receive in the event of a no-fault termination, it accepted the trial court's finding that the compensation committee had the minimum information required to exercise its duty of due care.n20:

In our view, a helpful approach is to compare what actually happened here to what would have occurred had the committee followed a 'best practices' (or 'best case') scenario, from a process standpoint. In a 'best case' scenario, all committee members would have received, before or at the committee's first meeting on September 26, 1995, a spreadsheet or similar document prepared by (or with the assistance of) a compensation expert (in this case, Graef Crystal). Making different, alternative assumptions, the spreadsheet would disclose the amounts that Ovitz could receive under the O[vitz] E[mployment] A[greement] in each circumstance that might foreseeably arise The contents of the spreadsheet would be explained to the committee members, either by the expert who prepared it or by a fellow committee member similarly knowledgeable about the subject. That spreadsheet, which ultimately would become an exhibit to the minutes of the compensation committee meeting, would form the basis of the committee's deliberations and decision. Had that scenario been followed, there would be no dispute (and no basis for litigation) over what information was furnished to the committee members or when it was furnished. Regrettably, the committee's informational and decision making process used here was not so tidy. That is one reason why the Chancellor found that although the committee's process did not fall below the level required for a proper exercise of due care, it did fall short of what best practices would have counseled.

....

[T]he issue may be framed as whether the compensation committee members knew, at the time they approved the OEA, that the value of the option component of the severance package could reach the \$92 million order of magnitude if they terminated Ovitz without cause after one year. The evidentiary record

shows that the committee members were so informed. On this question the documentation is far less than what best practices would have dictated. There is no exhibit to the minutes that discloses, in a single document, the estimated value of the accelerated options in the event of a[n] N[o] F[ault] T[ermination] ... after one year. The information imparted to the committee members on that subject is, however, supported by other evidence, most notably the trial testimony of various witnesses about spreadsheets that were prepared for the compensation committee meetings.

... .

It is on this record that the Chancellor found that the compensation committee was informed of the material facts relating to an NFT payout. If measured in terms of the documentation that would have been generated if 'best practices' had been followed, that record leaves much to be desired. The Chancellor acknowledged that, and so do we. But, the Chancellor also found that despite its imperfections, the evidentiary record was sufficient to support the conclusion that the compensation committee had adequately informed itself of the potential magnitude of the entire severance package, including the options, that Ovitz would receive in the event of an early NFT.

Under these circumstances, the Delaware Supreme Court upheld the trial court's ruling that the decisions of the Disney directors regarding Michael Ovitz's compensation and termination of employment were consistent not only with their duty of due care, but also with their duties of loyalty and good faith, and therefore protected by the business judgment rule.ⁿ²¹

In *In re Viacom Inc. Shareholders' Litigation*,ⁿ²² the court denied a motion to dismiss a shareholders' derivative action seeking, among other things, to recover compensation allegedly wrongfully paid to senior executive officers. Finding that the plaintiff had raised sufficient questions of fact about the independence of the members of the compensation committee to avoid dismissal on the basis of the business-judgment rule, the court held that the board's challenged decision to award the compensation in question should be tested under the "entire fairness" doctrine.ⁿ²³ The *Viacom* case is discussed at *section 16.01[4]*, below.

In *People v. Grasso*,ⁿ²⁴ the New York Attorney General sued Richard Grasso, the former Chairman of the Board and Chief Executive Officer of the New York Stock Exchange, as well as Kenneth Langone, the former chairman of its board compensation committee, for allegedly excessive compensation paid to Mr. Grasso. While the main claims in the case were brought under the New York not-for-profit corporation law, and therefore included some features not found in cases involving the compensation of executive officers of for-profit corporations, the case included breach-of-fiduciary-duty claims against Messrs. Grasso and Langone and called into question the independence of the compensation committee chairman, the information provided to the committee, and the adequacy and soundness of its proceedings.

What, then, are the lessons of the *Disney* derivative litigation for corporate secretaries, board counselors, directors in general and compensation committee members in particular? There are two main lessons:

1. Service on the board or the compensation committee of the board of a public corporation should not be considered an unduly risky proposition as long as the director acts in good faith and the director and the corporate secretary follow certain basic procedures, including:
 - (for the corporate secretary) giving sufficient advance notification of board and committee meetings and of the agenda for each meeting;
 - providing (in the case of the corporate secretary) and reviewing (in the case of the director), in advance of the meeting, adequate information, including written materials,

relating to major issues to come before the board or board committee (with greater detail and more information required as the importance to the overall corporation of the transaction in question increases);

- when appropriate, relying in good faith on reputable experts, retained independently by the board or board committee, with an appropriate amount of interaction with and questioning of each such expert, to be followed by further action with respect to the expert if the directors come to have actual knowledge that the expert's report or analysis is incomplete or misleading (a circumstance that should be rare); and

- allowing an appropriate amount of time for an active and complete discussion (during one or more board or committee meetings, depending on the complexity and overall materiality of the transaction to be considered) before the board or committee votes to authorize or ratify the transaction in question.

2. Notwithstanding the lower threshold for fulfillment of directors' fiduciary duties, no board or compensation committee will want to be criticized, or to expose the company to criticism, for failure to follow best practices in corporate governance, at least when there is some consensus about what those practices are.ⁿ²⁵

[2] 2006 Revisions to the SEC Compensation Disclosure Rules

In August 2006, the SEC revised its disclosure rules related to executive compensation and related-party transactions.ⁿ²⁶ In addition to adding extensive new disclosure requirements on executive compensation and related-party transactions, the new rules also prescribed annual disclosures relating to compensation committee proceedings.ⁿ²⁷ The revised disclosure rules require SEC registrants annually to disclose the following information:

(1) if the registrant does not have a standing compensation committee or committee performing similar functions, the basis of the board of directors' view that it is appropriate not to have a committee and the name of each director who participates in the consideration of executive officer and director compensation;

(2) whether the compensation committee has a charter and, if so, whether a current copy of the charter is available on the registrant's web site (and, (i) if so, the web site address must be provided, or (ii) if not, the charter must be included as an appendix to the registrant's proxy statement or information statement provided to security holders at least once every three fiscal years or whenever it has been amended since the beginning of the most recent fiscal year, and the fiscal year in which it was last so included in satisfaction of this requirement must be identified);

(3) a narrative description of the registrant's processes and procedures for consideration and determination of executive compensation, including

- (i) (A) the scope and authority of the compensation committee or persons performing similar functions, and (B) the extent to which the compensation committee may delegate its authority to other persons, identifying such other persons and the authority that may be delegated;

- (ii) any role of executive officers in determining or recommending the form or amount of executive and director compensation; and

(iii) any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether they are retained directly by the compensation committee (or persons performing similar functions), the nature and scope of their assignment, and the material elements of the instructions or directions given to them;

(4) under the caption "Compensation Committee Interlocks":

(i) if the registrant had a board compensation committee (or other board committee performing similar functions), the identity of each person who was a member of that committee during the last completed fiscal year and whether each such member (A) was an employee of the registrant, (B) was formerly an employee of the registrant, or (C) had any relationship requiring disclosure under Item 404 of Regulation S-K (on related-party transactions), or

(ii) if the registrant had no such committee, the identity of each officer or employee and any former officer who, during the last completed fiscal year, participated in board deliberations concerning executive compensation; and

(iii) the existence, and a description, of any of the following relationships during the last completed fiscal year:

(A) an executive officer's service as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of such a committee, the entire board of directors) of another entity, one of whose executive officers was on the compensation committee (or other board committee performing equivalent functions or, in the absence of such a committee, the entire board of directors) of the registrant;

(B) an executive officer's service as a director of another entity, one of whose executive officers was on the compensation committee (or other board committee performing equivalent functions or, in the absence of such a committee, the entire board of directors) of the registrant; and

(C) an executive officer's service as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of such a committee, the entire board of directors) of another entity, one of whose executive officers served as a director of the registrant.

(5) Under the caption "Compensation Committee Report":

(i) The compensation committee must disclose whether:

(A) it has reviewed and discussed with management the registrant's Compensation Discussion and Analysis (the registered company's annual executive compensation discussion required under the 2006 rules); and

(B) on the basis of that review and discussion, the committee recommended to the board of directors that the Compensation Discussion and Analysis be included in the company's annual disclosure document (the Annual Report on Form 10-K, proxy statement, or information statement to security holders); and

(ii) the name of each member of the registrant's compensation committee (or other board committee performing equivalent functions or, in the absence of such a committee, the entire board of directors), appearing below the disclosures described in subparagraph (5)(i), *above*.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Causes of Action General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses Business Judgment Rule Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting General Overview

FOOTNOTES:

(n1)Footnote 1. *What's Wrong with Executive Compensation?: A Roundtable Moderated by Charles Elson*, Harv. Bus. Rev. at 68 (Jan. 2003).

(n2)Footnote 2. *Brehm v. Eisner*, 746 A.2d 244, 249 (Del. 2000) (Veasey, C.J.) ("*Disney I*").

(n3)Footnote 3. *Disney I*, 746 A.2d at 251 (emphasis in original).

(n4)Footnote 4. *Disney I*, 746 A.2d at 255-256 .

(n5)Footnote 5. *Disney I*, 746 A.2d at 261 .

(n6)Footnote 6. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) ("*Disney II*").

(n7)Footnote 7. See discussion of exculpation under DGCL § 102(b)(7) in § 5.02 *above* .

(n8)Footnote 8. *Disney II*, 825 A.2d at 278 (emphasis in original).

(n9)Footnote 9. *In re Walt Disney Co. Derivative Litig.*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) ("*Disney III*").

(n10)Footnote 10. *Disney III*, 2005 Del. Ch. LEXIS 113, at *3-5 .

(n11)Footnote 11. *Disney III*, 2005 Del. Ch. LEXIS 113, at *175 (emphasis in original). Chancellor Chandler went on to observe: "Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct."

(n12)Footnote 12. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1984) .

(n13)Footnote 13. *Disney III*, 2005 Del. Ch. LEXIS 113, at *212 . The court elaborated the point by observing that "it is beyond question that the \$734 million sale of Trans Union was material and significantly larger than the financial ramifications to the Company of Ovitz's hiring." *Id.* at *213 .

(n14)Footnote 14. *Disney III*, 2005 Del. Ch. LEXIS 113, at *216-*217 . In a footnote that should be considered a word to the wise board counselor and keeper of compensation committee minutes, the court noted that "[i]t would have been extremely helpful to the Court if the minutes had indicated in any fashion that the discussion relating to the ... [Ovitz contract] was longer and more substantial than the discussion relating to the myriad of other issues brought before the compensation committee that morning." *Id.* at *216, n.539 .

(n15)Footnote 15. *Disney III*, 2005 Del. Ch. LEXIS 113, at *217-*218 .

(n16)Footnote 16. *Disney III, 2005 Del. Ch. LEXIS 113, at *219* .

(n17)Footnote 17. *Disney III, 2005 Del. Ch. LEXIS 113, at *220-*221* .

(n18)Footnote 18. *Disney III, 2005 Del. Ch. LEXIS 113, at *227-*228* .

(n19)Footnote 19. *In re Walt Disney Company Litigation, No. 41,2005, 2006 Del. LEXIS 307* , 37 Empl. Ben. Cas. (BNA) 2736 (June 8, 2006).

(n20)Footnote 20. *In re Walt Disney Company Litigation, No. 41,2005, 2006 Del. LEXIS 307, *66-*73* .

(n21)Footnote 21. *In re Walt Disney Company Litigation, No. 41,2005, 2006 Del. LEXIS 307, *84-*104* .

(n22)Footnote 22. No. 602527/05, *2006 N.Y. Misc. LEXIS 2891, 235 NYLJ 126 (NY S. Ct., June 23, 2006)* .

(n23)Footnote 23. *Viacom, 2006 N.Y. Misc. LEXIS 2891 at *18-*20* ("The entire fairness two prong test usually applies in cases whereby courts assess the fairness of a merger to the shareholders. It is also appropriate to apply the entire fairness analysis to evaluate the fairness of the executives' compensation package").

(n24)Footnote 24. *People v. Grasso, 2006 NY Slip Op 26095* , *; *12 Misc. 3d 384* , **; *816 N.Y.S.2d 863* , ***; *2006 N.Y. Misc. LEXIS 484 (March 15, 2006)* ; *see also* decision on subsequent motions to dismiss, *People v. Grasso, 2006 NY Slip Op. 52019U* , *; *2006 N.Y. Misc. LEXIS 3023* , ** , (Oct. 18, 2006), *13 Misc. 3d 1227A, 831 N.Y.S.2d 349* .

(n25)Footnote 25. For guidance on such practices, *see § 10.06[1] and [2] below*.

(n26)Footnote 26. SEC Release Nos. 33-8732A, 34-54302A, "Executive Compensation and Related Person Disclosure," *71 Fed. Reg. 53158 (Sept. 8, 2006)* .

(n27)Footnote 27. SEC Release Nos. 33-8732A, 34-54302A, "Executive Compensation and Related Person Disclosure," *71 Fed. Reg. 53158 (Sept. 8, 2006)*, at 53257-53258 , adding new item 407(e) to Regulation S-K, 17 CR 229.407.

(n28)Footnote 28. For purposes of these Compensation Committee Interlock disclosure rules, an "entity" does not include an entity that is tax-exempt under *Internal Revenue Code § 501(c)(3)*.

* The authors gratefully acknowledge the assistance of Dina Bernstein, an associate at Gibson, Dunn & Crutcher, with the updates to this chapter.



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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice § 10.04

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§ 10.04 Compensation Committee Charter, Scope and Purpose

[1] NYSE Requirements for Compensation Committee Charter

In November and December, 2003, the Securities and Exchange Commission (the "SEC") approved new corporate governance rules for the NYSE, the NASDAQ and the Amex.ⁿ¹ Section 303A.05 of the NYSE corporate governance standards deals with compensation committees of listed companies.ⁿ² Section 303.05(a) deals with the independence of compensation committee members, a subject that will be treated in detail elsewhere in this chapter.ⁿ³ Section 303.05(b) deals with compensation committee charters.

Like other provisions of the NYSE corporate governance rules, the rules on compensation committees include both mandatory requirements (which must be followed by all NYSE-listed companies, on pain of delisting) and best practices recommendations.ⁿ⁴ Both the mandatory requirements and the best-practices recommendations of the NYSE rules for compensation committee charters are reflected in the sample charter annexed as Appendix 10-A to this chapter.

The most basic NYSE compensation committee requirements are that each listed company have a compensation committee consisting of independent directors and that each such committee have a written charter. The charter must include provisions addressing the compensation committee's purpose and responsibilities and providing for an annual performance evaluation of the committee.ⁿ⁵ The committee's purposes and responsibilities, at a minimum, must include direct responsibility to:ⁿ⁶

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and

(B) make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval; and

(C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC.

It is worth noting the extent to which the NYSE corporate governance rules expand on the role that public companies' compensation committees had typically played before their adoption. Read literally, subsection (b)(i)(A) of Section 303A.05 suggests that the compensation committee should measure *all* of the CEO's compensation (including base salary) according to the committee's assessment of the CEO's performance against pre-determined performance objectives. Surely, the adoption of this requirement does not preclude compensation committees from giving substantial weight to competitive considerations (as, in fact, the NYSE recognizes in its commentary to the rule⁷), but it underscores policymakers' increasing emphasis on performance-based CEO compensation.

In addition to emphasizing the trend toward more performance-based compensation for CEOs, subsection 303A.05(b)(i)(A) also mandates a larger role for the compensation committee in the area of overall objective-setting for CEOs (in this way, too, reinforcing the link between company performance and CEO compensation). The rule *requires* the compensation committee to "review and approve performance goals and objectives relevant to CEO compensation" (again, not only in connection with qualified performance-based compensation under *IRC Section 162(m)*). Board compensation committees had long passed on CEOs' base salaries, as well as bonuses, of course, but subsection 303A.05(b)(i)(A) further highlights the compensation committee's central role in determining the CEO's overall agenda for the coming year. As a fundamental corporate governance matter, this directive emphasizes the link between CEO compensation and the advancement of corporate objectives, as mediated by the board compensation committee.

The directive of subsection 303A.05(b)(i)(A), of course, leaves open a wide variety of possibilities for how the compensation committee interacts with other board committees and with the board as a whole in the area of CEO objective-setting and performance assessment, but it certainly suggests that the compensation committee has an important role in this process, beyond *IRC Section 162(m)* qualified performance-based compensation (which base salary never is). Directors, as well as corporate secretaries and general counsels, should give careful consideration to the allocation of responsibilities among the board committees and the board as a whole with regard to setting CEO performance objectives and evaluating the CEO's performance against those objectives at the end of the year.⁸

In its commentary to subsection 303A.05(b)(i)(A) of the corporate governance rules, the NYSE suggests (but does not mandate) that the compensation committee charter also address:

- committee member qualifications;
- committee member appointment and removal;
- committee structure and operations (including authority to delegate to subcommittees); and
- committee reporting to the board.

The NYSE also suggested that the committee have the sole authority to hire, set the compensation and other terms of engagement of, and fire any compensation consultant who assists in the evaluation of director, CEO or senior executive compensation. While the direct retention and control of compensation consultants is not a legal requirement or even a mandatory SRO listing standard, it has become the recognized best practice and is increasingly the norm, as discussed below.⁹

The NYSE corporate governance rules mandate only that the compensation committee take direct responsibility ("either as a committee or directly with other independent directors") for CEO compensation and "make recommendations to the board with respect to non-CEO compensation."¹⁰ Because of the application of *IRC Section 162(m)* to the "Named Executive Officers" (that is, the CEO and the other four most highly compensated executive officers, other than the chief financial officer), and because plans designed to comply with Section 162(m)'s exception for performance-based compensation are normally administered by the compensation committee, it is the practice in many companies to have

the compensation committee review and approve the overall compensation, and its various elements (including base salary as well as performance-based incentive plan awards), for all Named Executive Officers, but there is no law, regulation or listing rule requiring that compensation committees of NYSE-listed companies be directly responsible for the compensation of anyone other than the CEO.

Finally, as in the case of the other independent board committees and the board as a whole, the charter for the compensation committee of a NYSE-listed company must provide for an annual performance evaluation.ⁿ¹¹ The NYSE listing requirements do not prescribe any particular format or procedure for the performance evaluation. Some companies have implemented an annual self-evaluation procedure for the compensation committee members; others assign responsibility for the evaluation to other independent members of the board, such as the corporate governance and nominating committee. A form of compensation committee self-assessment questionnaire is annexed to this chapter as Appendix 10-B.

[2] Compensation Committee Responsibilities for NASDAQ- and Amex-Listed Companies

The NASDAQ and Amex corporate governance rules mandate that decisions about both CEO compensation and compensation of "all other executive officers"ⁿ¹² be determined either by

- (a) the compensation committee composed of independent directors, or
- (b) the independent directors of the board.ⁿ¹³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Self-Regulating Entities National Association of Securities Dealers Securities Law Self-Regulating Entities National Securities Exchanges American Stock Exchange Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange Tax Law Federal Income Tax Computation Deductions for Business Expenses Business, Entertainment & Trade Expenses (IRC secs. 162, 274)

FOOTNOTES:

(n1)Footnote 1. *See* SEC Release No. 34-48745 (Nov. 4, 2003); SEC Release No. 34-48863 (Dec. 1, 2003). Certain clarifying amendments were made to the 2003 releases. *See* SEC Release No. 34-50625 (Nov. 3, 2004). *See also* the SEC website at www.sec.gov for all SRO-related releases.

(n2)Footnote 2. *See* NYSE Listed Company Manual § 303A.05. The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n3)Footnote 3. *See* § 10.05[1] below.

(n4)Footnote 4. The NYSE rules signal mandatory requirements by using the word "must"; the rules denote best-practices recommendations with the word "should." *See* Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002, at n. 2, *available at* www.nyse.com/pdfs/corp_gov_pro_b.pdf.

(n5)Footnote 5. NYSE Listed Company Manual § 303A.05(b)(i), (ii).

(n6)Footnote 6. NYSE Listed Company Manual § 303A.05(b)(i).

(n7)Footnote 7. NYSE Listed Company Manual § 303A.05(b)(i) Commentary ("In determining the long-term

incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years.").

(n8)Footnote 8. *See* § 6.02[8][c] *above* discussing guidelines regarding CEO evaluations.

(n9)Footnote 9. *See, e.g.*, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 4 (2003) ("The consultants should be hired by and report directly to the committee (or the board, if there is no committee), and should not be retained by the company in any other capacity."); Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 1, Executive Compensation, Specific Best Practice Suggestion 1, *available at* www.conference-board.org/pdf_free/758.pdf ("The Compensation Committee should retain any outside consultants who advise it, and the outside consultants should report solely to the Committee").

(n10)Footnote 10. NYSE Listed Company Manual § 303A.05(b)(i)(A),(B).

(n11)Footnote 11. NYSE Listed Company Manual § 303A.05(b)(ii).

(n12)Footnote 12. *See* the definition of "executive officer" under the 1934 Act, *17 CFR § 240.3b-7* (defining the term to include the issuer's "president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant").

(n13)Footnote 13. NASDAQ Rule 5605(d)(1), (2); Amex Company Guide § 805(a). NASDAQ Rule 5605 is reproduced in Appendix C to this treatise. For a mapping of the old rules onto the new rules, *see* http://www.nasdaq.com/about/ListingRules_ReferenceTable.pdf.

* The authors gratefully acknowledge the assistance of Dina Bernstein, an associate at Gibson, Dunn & Crutcher, with the updates to this chapter.



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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice § 10.05

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§ 10.05 Compensation Committee Composition

[1] Compensation Committee Independence

There are three major sets of independence requirements that apply to compensation committees of public company boards:

- the *IRC Section 162(m)* requirements;
- the 1934 Act Rule 16b-4 requirements;ⁿ¹ and
- the NYSE, Amex and NASDAQ corporate governance rules.ⁿ²

Further, on July 16, 2009, the U.S. Treasury introduced legislation that, if passed, would impose additional independence standards on compensation committees.ⁿ³ The proposed legislation would require that members of compensation committees meet new independence standards, as Sarbanes-Oxley did for member of audit committees. Under the proposed legislation, a member of the compensation committee of a company may not, other than in his or her capacity as a member of the compensation committee, the board of directors or any other board committee: (i) accept any consulting, advisory, or other compensatory fee from the company, or (ii) be an affiliated person of the company or any of its subsidiaries. The proposed legislation would further require that compensation committees be given the authority and funding to hire independent compensation consultants, outside counsel and other advisors and that any compensation consultants and legal counsel hired by compensation committees be independent of management.

In addition, several sets of corporate governance "best practices" guidelines address the independence of the compensation committee, as well.ⁿ⁴

[a] IRC Section 162(m) Independence Requirements

The regulations under Section 162(m), with which companies must comply to be eligible for the federal income tax deduction of compensation over \$1 million paid to "Named Executive Officers" (other than the chief financial officer)

under the qualified performance-based compensation exception,ⁿ⁵ include detailed independence requirements. Under the Section 162(m) regulations, the qualified performance-based compensation exception is available only if the compensation is paid solely on account of the attainment of one or more pre-established objective performance goals,ⁿ⁶ which must be set by a committee of two or more "outside directors."ⁿ⁷

To qualify as an outside director for Section 162(m) purposes, a board member must not:ⁿ⁸

- (A) be a current employee of the company;
- (B) be a former employee who, during the taxable year, receives compensation from the company for prior services (except under a tax-qualified retirement plan);
- (C) have been an officer of the company; or
- (D) receive remuneration from the company, directly or indirectly, other than as a director. This includes any payment for goods or services.

[b] 1934 Act Rule 16b-3 Independence Requirements

1934 Act Rule 16b-3 allows the board as a whole or a committee of two or more "Non-Employee Directors," by approving non-discretionary equity grants from the issuer to Section 16(b) insiders, to exempt such transactions from the short-swing trading rules under 1934 Act Section 16(b). While there is no requirement that the board compensation committee fulfill this role--and it is entirely acceptable, for example, for the board to constitute an *ad hoc* committee of two or more Non-Employee Directors for purposes of approving a stock grant pursuant to Rule 16b-3--often it will be convenient (and it is certainly logical) for the board compensation committee to act as the committee of Non-Employee Directors under Rule 16b-3. Therefore, many public companies constitute their compensation committees in a manner that will allow them to perform this duty, as well.

To a certain extent, the Rule 16b-3 requirements for Non-Employee Directors overlap with the "outside director" rules under *IRC Section 162(m)*.ⁿ⁹ Nevertheless, in certain respects, the Rule 16b-3 requirements add other, distinct factors that disqualify a director as a Non-Employee Director. Under Rule 16b-3, a Non-Employee Director may not (1) receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K, *17 CFR § 229.404(a)* (generally, \$120,000); or (2) have an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) (any transaction over \$120,000 in which the director would have a direct or indirect material interest).ⁿ¹⁰

[c] SRO Independence Requirements; Putting It All Together

[i] All-Purpose Compensation Committee Independence for NYSE-Listed Companies

In addition to adhering to the rules under *IRC Section 162(m)* and 1934 Act Rule 16b-3 for the purposes of that section and rule, respectively, NYSE-, Amex- or NASDAQ-listed companies must also comply with the general independence requirements under the SRO corporate governance rules. These requirements apply to all three key board committees, including the compensation committee.

Thus, for a member of a NYSE-listed company's board compensation committee, the board of directors as a whole must affirmatively determine that the committee members have no material relationship with the listed company other than as directorsⁿ¹¹ and the following general director independence criteria must be met:ⁿ¹²

- (i) A director who, in the past three years, has been an employee, or has had an immediate family member who has been an executive officer, of the listed company is not independent.
- (ii) A director is not independent if, in any 12-month period within the last three years, he or she has received, or has had an immediate family member who has received, more than \$120,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).ⁿ¹³
- (iii) A director is not independent if he or she (A) is or has an immediate family member who is a current partner of a firm that is the company's internal or external auditor or (B) is a current employee of such a firm, or (C) has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, or (D) has been or who has had an immediate family member who has been, within the last three years (but is no longer), a partner or employee of such a firm who personally worked on the listed company's audit.
- (iv) A director is not independent if, within the last three years, he or she has been employed, or has had an immediate family member who has been employed as an executive officer of another company where any of the listed company's present executives concurrently served on that company's compensation committee.
- (v) A director is not independent if he or she is a current employee, or has an immediate family member who is a current executive officer, of a company that has, in any of the last three fiscal years, made payments to, or received payments from, the listed company for property or services in an amount which, in any such year, exceeded the greater of \$1 million or 2 percent of such other company's consolidated gross revenues.

In addition, to be able (a) to take those actions necessary to preserve the federal income tax deductibility of "qualified performance-based compensation" when total compensation for named executive officers exceeds \$1 million, and (b) to approve equity grants to Section 16 insiders, thus exempting such transactions from the short-swing trading rules of Section 16(b), directors serving on compensation committees of NYSE-listed companies must not:ⁿ¹⁴

- (a) receive any compensation for prior services as an employee of the company (even if the employment ended more than three years before), except under a tax-qualified retirement plan;
- (b) have been an officer of the company (at any time);
- (c) receive any remuneration from the company, directly or indirectly, other than as a director; or
- (d) have an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K, *17 CFR § 229.404(a)* (any transaction over \$120,000 in which the director would have a direct or indirect material interest).

[ii] *All-Purpose Compensation Committee Independence for NASDAQ- and Amex-Listed Companies*

For NASDAQ- or Amex-listed companies, compensation committee members must not have any relationship with the listed company that, in the opinion of the board, would interfere with the exercise of their independent judgment in carrying out their responsibilities as directors.ⁿ¹⁵ For NASDAQ- and Amex-listed companies:

- (i) in the past three years, no committee member may have been employed by the company or any of its

parents or subsidiaries (except, in the case of Amex companies, for prior employment as an executive officer and not for more than 1 year);ⁿ¹⁶

(ii) no committee member, or family member of a committee member, may in any period of twelve consecutive months within the three years preceding the determination of independence, have accepted payments from the company or any of its parents or subsidiaries in excess of \$120,000, except;

(a) compensation for board or board committee service;

(b) for Amex only, compensation received for former service as an interim executive officer (provided the interim employment did not last longer than one year)

(c) compensation paid to a family member who is an employee--but not an executive--of the company or any of its parents or subsidiaries; or

(d) benefits under a tax-qualified retirement plan; or

(e) non-discretionary compensation;

(iii) in the past three years, no or family member of a committee member may have been employed by the company or any of its parents or subsidiaries as an executive officer;ⁿ¹⁷

(iv) in the current fiscal year or any of the past three fiscal years (in the case of NASDAQ-listed companies) or in any of the most recent three fiscal years (in the case of Amex-listed companies), no committee member or family member of a committee member may have been a partner in, or controlling shareholder or executive officer of, any organization to which the company made, or from which the company received, payments (other than payments arising solely from investments in the company's securities) that exceed five percent of the recipient's (in the case of NASDAQ-listed company's) or the organization's (in the case of Amex-listed companies) consolidated gross revenues for that year or \$200,000, whichever is greater, except:

(a) payments arising solely from investments in the company's securities; or

(b) payments under non-discretionary charitable contribution matching programs;ⁿ¹⁸

(v) during the past three years (in the case of NASDAQ-listed companies) or the most recent three fiscal years (in the case of Amex-listed companies), no committee member or family member of a committee member may have been an executive officer of another entity whose board compensation committee has included any of the executive officers of the listed company;ⁿ¹⁹ and

(vi) no committee member or family member of a committee member may be a current partner of the company's outside auditor, or, during the past three years, have been a partner or employee of the company's outside auditor who worked on the company's audit.ⁿ²⁰

For NASDAQ-listed companies, in each of these cases, a family member is a committee member's spouse, parent, child or sibling, whether by blood, marriage or adoption, or anyone residing in the committee member's home.ⁿ²¹ In each of the rules referring to a "family member" in the foregoing summary, the Amex rules use the term "immediate family member," which is defined similarly to mean "a person's spouse, parent, children, siblings, mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law and anyone who resides in such person's home (other than domestic employees)."ⁿ²² In the case of an investment company, both the NASDAQ rules and the Amex rules preclude

any "interested person" as defined under Section 29(a)(19) of the Investment Company Act of 1940 (other than in his or her capacity as a member of the board of directors or any board committee) from qualifying as independent and substitute that prohibition for the independence rules set forth above.ⁿ²³

Both the NASDAQ rules and the Amex rules allow companies to make an exception for one non-independent member of a compensation committee consisting of at least three directors as long as that director is not a current officer or employee or family member of a current officer or employee "if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders and the board discloses, in the next annual meeting proxy statement subsequent to such determination, the nature of the relationship and the reasons for the determination." Such non-independent director, however, may serve for no longer than two years.ⁿ²⁴ The narrowness of the exception makes it unlikely that it will often be invoked.

In addition, to be able (a) to take those actions necessary to preserve the federal income tax deductibility of "qualified performance-based compensation" for named executive officers whose total compensation exceeds \$1 million, and (b) to approve equity grants to Section 16 insiders, thus exempting such transactions from the short-swing trading rules of Section 16, members of compensation committees of NASDAQ- and Amex-listed companies must not:ⁿ²⁵

- (a) receive any compensation for prior services as an employee of the company (even if the employment ended more than three years before), except under a tax-qualified retirement plan;
- (b) have been an officer of the company (at any time);
- (c) receive any remuneration from the company, directly or indirectly, other than as a director; or
- (d) have an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K, *17 CFR § 229.404(a)* (any transaction over \$120,000 in which the director would have a direct or indirect material interest).

[2] Other Attributes for Compensation Committee Membership

Unlike in the case of the audit committee, no rule or listing standard absolutely requires that compensation committee members have backgrounds in executive compensation issues or any other prescribed expertise. Nevertheless, best practices guidelines recommend special or continuing education for committee members in compensation-related issues.ⁿ²⁶

Legal Topics:

For related research and practice materials, see the following legal topics:
 Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Directors, Officers & Principal StockholdersShort Swing TradingSecurities LawSelf-Regulating EntitiesNational Association of Securities DealersSecurities LawSelf-Regulating EntitiesNational Securities ExchangesAmerican Stock ExchangeSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock ExchangeTax LawFederal Income Tax ComputationDeductions for Business ExpensesBusiness, Entertainment & Trade Expenses (IRC secs. 162, 274)

FOOTNOTES:

(n1)Footnote 1. *17 CFR § 240.16b-3*.

(n2)Footnote 2. In addition, in November 2006, the SEC adopted amendments to the tender offer "best price" rule (*17 CFR § 240.13e-4*) providing a safe harbor for compensation, severance or employee-benefit arrangements approved

by an independent compensation committee of the target company or the bidder in certain circumstances, so that payments pursuant to such arrangements would not be considered part of the "best price" that must be offered to all shareholders because the executive receiving the compensation is also a shareholder of the target company. SEC Release Nos. 34-54684, "Amendments to Tender Offer Best- Price Rules," *71 FR 65393 (Nov. 8, 2006)*. In general, the independence requirements for the safe harbor are those under the listing standards of the applicable self-regulatory organization.

(n3)Footnote 3. Press release regarding July 16, 2009 legislation is *available at* http://www.financialstability.gov/latest/tg_07162009.html.

(n4)Footnote 4. *See, e.g.*, Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations (2002), Part 1, Executive Compensation, Specific Best Practice Suggestion 2, *available at* www.conference-board.org/pdf_free/758.pdf; Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 15 (2003).

(n5)Footnote 5. *26 CFR § 1.162.27(e)*.

(n6)Footnote 6. *26 CFR § 1.162.27(e)(2)*.

(n7)Footnote 7. *26 CFR § 1.162.27(e)(3)*.

(n8)Footnote 8. *26 CFR § 1.162.27(e)(3)*.

(n9)Footnote 9. Thus, for example, under 1934 Act Rule 16b-3, a Non-Employee Director must not be an officer or employee of the registrant, its parent or any subsidiary. *17 CFR § 240.16b-3(b)(3)(i)(A)*.

(n10)Footnote 10. *17 CFR § 16b-3*.

(n11)Footnote 11. *See* NYSE Listed Company Manual § 303A.02(a).

(n12)Footnote 12. *See* NYSE Listed Company Manual § 303A.02(b).

(n13)Footnote 13. Neither (a) compensation received by the director for former service as an interim Chairman or CEO or other executive officer, nor (b) compensation received by an immediate family member for service as a non-executive employee is required to be taken into account for purposes of this test. NYSE Listed Company Manual § 303A.02(b)(ii) Commentary.

(n14)Footnote 14. *See 26 CFR § 1.162.27(e)(3); 17 CFR § 240.16b-3(b)(3)*.

(n15)Footnote 15. NASDAQ Rule 5605(a)(2); Amex Company Guide § 803(A)(2).

NASDAQ Rule 5605(a)(2) (definition of "Independent Director") and commentary thereto, are reproduced in Appendix C to this treatise.

(n16)Footnote 16. NASDAQ Rule 5605(a)(2)(A); Amex Company Guide § 803(A)(2).

(n17)Footnote 17. NASDAQ Rule 5605(a)(2)(C); Amex Company Guide § 803A(2)(c).

(n18)Footnote 18. NASDAQ Rule 5605(a)(2)(D); Amex Company Guide § 803A(2)(d).

(n19)Footnote 19. NASDAQ Rule 5605(a)(2)(E); Amex Company Guide § 803A(2)(e).

(n20)Footnote 20. NASDAQ Rule 5605(a)(2)(F); Amex Company Guide § 803A(2)(f).

(n21)Footnote 21. NASDAQ Rule 5605(a)(2).

(n22)Footnote 22. *See* Amex Company Guide § 803, commentary.01.

(n23)Footnote 23. NASDAQ Rule 5605(a)(2)(G); Amex Company Guide § 803A(3).

(n24)Footnote 24. NASDAQ Rule 4605(d)(3); Amex Company Guide § 805(b).

(n25)Footnote 25. *See* 26 CFR § 1.162.27(e)(3); 17 CFR § 240.16b-3(b)(3).

(n26)Footnote 26. *See, e.g.*, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 20 (2003) ("Continuing education is particularly important in the field of compensation, in light of the complexity and importance of this subject.").

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Corporate Governance: Law and Practice

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CHAPTER 10 THE COMPENSATION COMMITTEE *

1-10 Corporate Governance: Law and Practice § 10.06

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§ 10.06 Compensation Committee Process and Procedure

[1] Applicability of the Business Judgment Rule to Compensation Committee Decisions

Assuming that the compensation committee is constituted to meet the SRO independence requirements, and perhaps the *IRC Section 162(m)* and 1934 Act Rule 16b-3 independence rules, as well, any decision of the committee will be made by a group of outside directors duly authorized to make the decision. Thus, the compensation committee will already have a leg up on protecting its decisions under the business judgment rule.ⁿ¹

Nevertheless, in one case, the independence of outside board members was successfully attacked on the ground that the directors were motivated to entrench themselves through the adoption of change-in-control contracts under which large payments would be made to company executives upon the failure to re-elect a majority of the incumbent directors (or their designees).ⁿ² Thus, even when the transaction in question confers no monetary benefit on the outside directors, if it arguably tends to perpetuate their tenure in office, then its approval by a committee composed entirely of outside directors may not insulate it from attack under the business judgment rule.

Even when the transaction in question is approved by a committee of independent directors and cannot be plausibly argued to entrench them, the committee must proceed with care to maximize the likelihood that a court will respect their decision under the business judgment rule, without re-examining the decision on the merits. To accomplish this, it is necessary not only that the directors act in good faith but that they act with due care. In *Disney IV*, the Delaware Supreme Court rejected the plaintiff's attempt to "conflate" the duty of good faith with the duty of due care (by arguing that, by failing adequately to inform themselves, the directors had acted in bad faith).ⁿ³ While the court observed that, in view of its earlier finding that the Disney directors had acted on adequate information, the argument would have failed in any event, it nevertheless went on to expound on the duty of good faith,ⁿ⁴ enumerating three different categories of behavior that "are candidates for the 'bad faith' pejorative label."ⁿ⁵ The first category, the court observed, involves subjective bad faith--an actual intent to do harm. The second category that the court considered--"which is at the opposite end of the spectrum"--is gross negligence without malevolent intent. The court concluded that such gross negligence ("including a failure to inform one's self [sic] of material available facts"), without more, cannot constitute bad faith under Delaware law.ⁿ⁶

The "third category of fiduciary conduct, the court noted, falls between the first two categories" - "intentional dereliction of duties, a conscious disregard for one's duties"n7 The court stated that such conduct is "a non-exculpable, non-indemnifiable violation of the duty to act in good faith" but did not find that it had any application to the behavior of the Disney directors in the case before it.n8 On the facts before it, the court sustained the trial court's finding that the Disney directors had acted in good faith in approving the Ovitz employment agreement.n9

In a more recent case, the Delaware Supreme Court held that the duty of good faith is an aspect of the duty of loyalty, rather than an independent duty.n10 In that case, the Court cited approvingly its own decision in *Disney IV*, which remains instructive on the distinction between a breach of the duty of care, on the one hand, and a breach of the duty of good faith (an aspect of the duty of loyalty), on the other hand.

To pass muster under the business judgment rule, the directors must have taken the challenged actions not only in good faith, but with due care. They must have ample information (including, when necessary, advice from independent experts) and sufficient time to study it in advance of the meeting, and there must be a full and adequate discussion of the issues.n11 In addition, following the recommended best practices described in the following section should bolster the factual record that the committee acted with due care and upon adequate information, further supporting the argument for the application of the business judgment rule.

[2] Recommended Compensation Committee Practices

[a] Compensation Committee Independence--Beyond the Rules

At the heart of the business judgment rule, the SRO rules governing compensation committees of listed companies and influential best practices recommendations for compensation committees is the matter of independence. Nowhere is the "agency problem" that has resulted from the separation of ownership and management in the public company so apparent as it is in the area of executive compensation. Specifically, it is in the economic self-interest of the company's executives to maximize their own wealth, whether from participation in the equity of the company, from cash compensation (salary and cash bonuses under both annual plans and long-terms plans) or from benefits and perquisites. In contrast, it is in the interest of the company and the shareholders (to whom the compensation committee members owe the duty of loyalty) that the compensation of the company's executive officers be such as to maximize the wealth of the company, taking into account (a) the direct cost of compensation, as well as (b) the (ultimately unmeasurable) value produced by attracting and retaining the most effective executive team. In view of these divergent interests, ensuring board and committee independence from management is perhaps more clearly necessary in the area of executive compensation than in any other area.

The applicable "black letter" rules and listing standards for testing the independence of compensation committee members are discussed at length, above. In addition, in the post-Enron era, influential jurists, both in scholarly commentary and in recent decisions, have taken a more stringent view of independence than the courts had done before.n12

In view of the cases and the expressed views of influential jurists discussed above, to maximize the likelihood that the compensation committee's decisions will be protected under the business judgment rule (for example, in a shareholder derivative suit for waste of corporate assets), boards of directors should give careful consideration not only to any economic relations between compensation committee members and the company (which are covered in the formal rules), but also to social and community ties between compensation committee members and the company's senior executive management, in general, and the CEO, in particular.

Compensation committee members should be selected for nomination by a careful process run by an entirely independent board nominating (or corporate governance and nominating) committee,n13 without undue influence. Any connections between the prospective compensation committee member and the CEO (such as common schools, clubs,

participation in political, religious and social organizations, other fund-raising, and outside friendships) should be disclosed by the prospective board member and the CEO and should be carefully considered by the nominating committee in selecting candidates for nomination to the board and in appointing directors to the compensation committee.ⁿ¹⁴ While common interests and points of contact in community, charitable and political organizations between CEOs and directors of major companies are frequent and should not be considered disqualifying in and of themselves, in the post-Enron environment boards should be aware of and carefully weigh the totality of a director's relationships with the company and with the CEO in making a determination of independence.ⁿ¹⁵

In addition to formal, structural independence, compensation committee best practices stress the less objectively determinable but equally important quality of independence in fact in committee deliberations and decision-making processes.ⁿ¹⁶ While, unlike formal independence, behavioral independence is difficult to define and even more difficult to measure, one meaningful way of encouraging a culture of independent minded deliberation and decision-making is to make this a dimension of the committee's annual evaluation and to require compensation committee members (in companies where the committee does a self-evaluation) or other independent directors (to whom the responsibility for the annual evaluation of the compensation committee's performance is assigned in other companies) to give specific examples in support of their assessment of the compensation committee's behavioral independence.

[b] Compensation Committee Agendas and Meetings; Role at Annual Meeting of Shareholders

The chairman of the compensation committee, rather than the CEO or a member of the CEO's staff (such as the corporate secretary or head of human resources), should set the committee's agenda for the year and for each meeting. Certainly, in setting the agenda, it is appropriate for the committee chairman to consider suggestions from the CEO, the corporate secretary, the general counsel, the head of human resources, as well as outside advisors and other committee members. Nevertheless, the committee chairman should retain ultimate control over the content of the committee agendas and should be satisfied with the agenda before it is distributed to the entire committee, along with other materials, in preparation for each meeting.ⁿ¹⁷

In preparing the compensation committee agendas for the various committee meetings during the course of the year, it is helpful to start with a checklist of the regular duties that the compensation committee must discharge each year under its charter, company practice and applicable legal and listing requirements. The normal duties of the compensation committee (which vary somewhat depending on the nature of the company and on which exchange it is listed, as explained in the balance of this chapterⁿ¹⁸ include:

- reviewing and approving performance goals for the year (and for any multi-year cycles under long term incentive plans) relevant to the compensation of the CEO (perhaps in conjunction with another independent board committee--such as the corporate governance and nominating committee, or the non-management directors as a group);
- assessing the CEO's performance for the previous year (and for any multi-year cycles under long term incentive plans) against pre-established goals;
- determining (either alone or in conjunction with other independent directors or committees) the CEO's compensation level, on the basis of the committee's assessment of the CEO's performance and other factors (such as competitive pay levels in peer companies);
- in the case of incentive compensation intended to qualify as "qualified incentive-based compensation under *IRC Section 162(m)*"ⁿ¹⁹ reviewing performance against pre-established goals on the basis of objective measurements and certifying the extent to which such goals have been achieved;
- determining, or making recommendations (to the full board, the non-management directors as a

group), concerning (a) incentive-based compensation plans and equity-based plans in which senior officers other than the CEO may participate, and (b) base salary and bonuses for senior officers of the company other than the CEO;

- preparing, or reviewing and approving, the required compensation committee report in the annual proxy statement;
- administering company compensation plans (for example, where the compensation committee is the body vested with discretion to make stock option and restricted stock awards, not only as a matter of the regular annual compensation cycle but also in connection with inducement awards for new hires and awards in connections with mid-year promotions); and
- providing for an annual evaluation of the compensation committee's own performance.

In addition to the express duties assigned to the Compensation Committee, a rule adopted by the SEC in 2006 also requires compensation committees to approve the compensation of Executive Officers, including those who are not named executive officers in the proxy statement, or to disclose their compensation.ⁿ²⁰ Since few, if any, companies will choose to disclose the compensation of all executive officers whose compensation is not otherwise required to be disclosed in the proxy statement, compensation committees (or a committee of independent directors performing similar functions) will have to approve the compensation of such executive officers annually. For companies choosing to take advantage of this exception to the disclosure rule (as virtually every public company will do), an annual review and approval of total compensation of all executive officers should be planned and carried out as part of the regular compensation cycle (normally, for calendar-year companies, in the first quarter).

There is no legal or listing requirement that all compensation committee meetings be held entirely in executive session, outside the presence of the CEO or other company executives. Nevertheless, it is sound practice to have regularly scheduled executive sessions of the compensation committee. In addition, of course, discussion of the CEO's compensation should take place outside the presence of the CEO.ⁿ²¹ Likewise, discussion of compensation for other executive officers should take place outside their presence.

The Conference Board stresses the importance of the compensation committee's direct accountability to the shareholders, stipulating that the "Chair of the Compensation Committee should 'take ownership' of the Compensation Committee's activities and be available at shareholders' meetings to respond directly to questions about executive compensation."ⁿ²²

[c] Compensation Committee Information and Resources

The compensation committee must have the resources to acquire adequate relevant information to inform the decisions it makes. For most compensation committees, most of the time, such information will come from the company and also from retained experts.

In terms of information from the company, the committee should have complete and unfettered access to both records and personnel, as necessary for informed decision-making. The records to which the committee is most likely to require access are performance evaluations of executive officers below the CEO level, information relevant to company and unit performance (including financial measures and other relevant data), and salary and employment histories. The company personnel most likely to be able to provide such information to the committee, and to supplement the written records with their own informed and relevant perspectives, are the CEO, the head of human resources and, in some cases, the general counsel and chief compliance officer.

Like other board committees, the compensation committee should be able to retain independent experts of its own at the

company's expense. The NYSE listing standards do not require, but recommend, that the compensation committee charter give the compensation committee "sole authority to retain and terminate [the engagement of] the consulting firm, including sole authority to approve the firm's fees and other retention terms."ⁿ²³ Direct hiring of independent consultants by the board or the board compensation has become the commonly recognized best practice.ⁿ²⁴

[d] Tally Sheets

One specific technique for ensuring that the compensation committee has the required information has become a recognized best practice. It is the use of so-called tally sheets for senior executive officers.

A tally sheet is simply a schedule that summarizes and totals the value of the various elements of an executive's compensation, pension benefits and perquisites. While the exact components and how they are valued varies, many compensation directors and compensation consultants present the compensation committee with tally sheets that take account of salary, cash bonuses, cash long-term incentive compensation awards, restricted stock awards, stock option awards, perquisites, and company pension contributions (or, alternatively, increase in actuarial present value of pension).

Some consultants recommend that the compensation committee be presented, annually, with tally sheets not only for named executive officers whose compensation is required to be disclosed in the proxy statement but also for the members of a broader senior executive group. Depending on the size of the company, such a group might include 15 or 20 of the most highly compensated senior executives.

In addition, especially in light of the *Disney* case and the increased scrutiny of change-in-control arrangements, companies are well-advised to prepare, and to present their compensation committees with, tally sheets showing and summing the various elements of value that senior executive officers are eligible to receive upon a change in control of the company. Such tally sheets should take account not only of the payments and benefits to be provided under change-in-control agreements but also accelerated vesting and payouts upon a change-in-control under long-term incentive plans, stock option and restricted stock award agreements.

[e] Overall Thoroughness and Completeness of Compensation Committee Process

At the most general level, the message of recent cases and best practices recommendations regarding compensation committees is that, before making any decision relating to the compensation of a senior executive officer (especially the CEO), the compensation committee should go to the trouble and take the time to understand the following:

- (a) the total potential expense to the company-and value to the executive-of the compensation it is being asked to approve;
- (b) how the executive's proposed compensation compares with that of similarly situated executives in comparable companies; and
- (c) the relationship between the executive's proposed compensation and the company's performance for the relevant period.

In *Disney II*,ⁿ²⁵ the court had lambasted the compensation committee for utterly failing to understand the terms or the potential cost to the company of the Michael Ovitz employment agreement before approving it. Similarly, in his lawsuit against, among others, a former chairman of the NYSE board compensation committee for the payment of allegedly excessive compensation to former NYSE CEO Richard Grasso, New York's attorney general charged that the compensation committee "wholly disregarded" available information about how Mr. Grasso's compensation compared to "benchmark" compensation figures that the NYSE's human resources staff and compensation consultants had calculated

to take account of (a) the median compensation paid to chief executive officers of a comparator group and (b) an assessment of the NYSE's performance for each relevant period.ⁿ²⁶ To avoid these sorts of charges, compensation committees should review and understand, and make their decisions about executive compensation in light of, complete and accurate information about (i) the proposed compensation arrangements before them, (ii) compensation paid to similarly situated executives in comparable companies, and (iii) the relationship between the proposed compensation and the company's performance for the period in question.

[3] Review and Discussion with Management of Compensation Disclosure and Analysis

Under the disclosure rules for executive compensation and related-party transactions adopted by the Securities and Exchange Commission in August of 2006, companies must include, in their annual disclosure documents, a detailed compensation discussion and analysis ("CD&A"). The CD&A is management's disclosure, rather than the compensation committee's disclosure, the detailed content of which is outside the scope of this work.

Under the 2006 rules, the compensation committee is required to include in the company's annual disclosure documents (normally, the proxy statement) a Compensation Committee Report, which must state (a) whether the compensation committee has reviewed and discussed the CD&A with management, and (b) whether, on the basis of that review and analysis, the compensation committee recommended to the board of directors that the CD&A be included in the Company's annual disclosure documents.ⁿ²⁷

Like many other rules adopted by the SEC since the passage of the Sarbanes-Oxley Act, in practical effect the August 2006 rules go considerably beyond disclosure. Although they do not expressly require that the compensation committee review and discuss the CD&A with management, few, if any, committees will want to disclose that they have not reviewed and discussed the CD&A with management. In practice, therefore, the Compensation Committee Report requirement amounts to an implied procedural mandate that the Committee review and discuss the CD&A with management.

This means that most compensation committees will want to build into their schedules, in the run-up to the meeting at which the Compensation Committee Report and the balance of the proxy statement are reviewed and approved (usually in the first or early second quarter for calendar-year filers), an adequate opportunity for senior executives (typically, the CEO and the head of HR, perhaps with the senior manager responsible for compensation matters) to present the CD&A to, and discuss it with, the compensation committee. Companies should consider whether this review and discussion should take place in a single meeting of the compensation committee in which the final CD&A will be discussed, reviewed and approved for inclusion in the proxy statement or, alternatively, whether the discussion and review should span two or more meetings.ⁿ²⁸

[4] IRC Section 162(m) Procedures

[a] Importance of IRC Section 162(m), Generally

The express legislative intent behind the adoption of *IRC Section 162(m)* was to reduce the level of senior executive compensation in public companies--a level that had become "the subject of scrutiny and criticism."ⁿ²⁹ To this end, Section 162(m) precludes public companies from deducting from income, for federal income tax purposes, the expense of any compensation of "covered employees" in excess of \$1 million in any taxable year, with certain important exceptions.ⁿ³⁰ The "covered employees" are the CEO (or acting CEO) and the four other most highly compensated officers (excluding the chief financial officer)ⁿ³¹ whose compensation is required to be disclosed under the 1934 Act.ⁿ³²

Despite the express legislative purpose of reducing executive compensation, the actual effect of Section 162(m) has been, rather, to steer executive compensation in a particular direction, indicated by one of the exceptions to the general

rule of non-deductibility--an exception that requires the compensation committee to be comprised in a particular way and to follow specified procedures. The compensation is deductible as long as it is payable "solely on account of the attainment of one or more performance goals," if three general conditions are met:³³

- (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors,
- (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and
- (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

This is often referred to as the "qualified performance-based compensation exception." The IRS regulations under Section 162(m), which provide detailed guidance on the specific procedures that must be followed to meet these requirements, are discussed below.

Starting with a pilot program in 2003, in examining the tax returns of public corporations the Internal Revenue Service has focused on, among other things, deductions for expenses of executive compensation, including the deductibility of compensation over \$1 million for each of the named executive officers listed in public companies' proxy statements.³⁴ The regulations under Section 162(m) are lengthy, detailed and specific. It would behoove any lawyer or corporate secretary assisting the board in connection with compensation intended to be eligible for the tax deduction for qualified performance-based compensation to read those regulations in their entirety. They are reproduced in full in Appendix 10-C to this chapter.

In general, the compensation committee should be involved in the process of designing and implementing Section 162(m)-compliant performance-based compensation plans at three critical junctures:

- (a) at the outset of the process, when the plan is prepared and submitted to a vote of the shareholders;
- (b) on an annual or other periodic basis, when the performance goals are set and awards are made under the plan; and
- (c) at the end of each performance period, when it is time to determine whether the goals have been met and what payouts are owing to named executive officers.

There are exacting regulatory standards governing each stage of the process. Because the design, implementation and administration of Section 162(m)-compliant incentive compensation plans tends to comprise a large part of the work of any public company compensation committee--and because the work of the compensation committee in this regard is governed by some of the most detailed and specific corporate governance rules on the books (albeit under the tax laws)--the following subsections will highlight the basic Section 162(m) requirements to which the compensation committee and its counselor should attend at each stage of the process.

[b] Step I: Preparing the Plan and Seeking Shareholder Approval

[i] *Shareholder Approval of Material Terms*

As a practical matter, the plan will be approved (for recommendation to the shareholders) by the compensation committee, but is normally prepared by counsel. Counselors to the compensation committee must be prepared to explain

the requirements for a Section 162(m)-compliant plan (outlined *above*) and to prepare a properly drafted plan for the committee to review and recommend to the shareholders (or to the board for approval and recommendation to the shareholders).

Once the compensation committee approves the plan, its material terms must be submitted to a vote of the shareholders for approval. Although the narrow legal requirement is that only the "material terms" of the plan must be approved by the shareholders before the compensation is paid,ⁿ³⁵ in practice, it is a good idea to summarize the material terms in the body of the proxy statement seeking shareholder approval for the plan and to reproduce the full plan as an exhibit. That way, there can be no question about full disclosure, for purposes of Section 162(m) or under the securities laws.

The material terms include:ⁿ³⁶

- (i) the employees eligible to receive compensation (not necessarily by name, but at least by title or class of employeeⁿ³⁷);
- (ii) a description of the business criteria on which the performance goal is based; and
- (iii) either (a) the maximum compensation that may be paid to any employee, or (b) the specific formula used to calculate the amount of compensation to be paid if the performance goal is attained (except that, if the formula is based, in whole or part, on a percentage of salary of base pay, the disclosure *must* include the maximum amount of compensation that may be paid to the employee).

[ii] Disclosure of Business Criteria

The disclosure of the business criteria on which the performance goal is based may include the general measure (for example, return on shareholders' equity), rather than the specific goal (such as return on shareholders' equity of at least 10 percent in a particular fiscal year).ⁿ³⁸ Moreover, it has become common practice to include a list of criteria from which the compensation committee may choose, such as the following:

The business criteria on which the performance goal may be based will be one or any combination of the following, for the Company or any identified business unit, as determined by the Committee:

- (i) net income,
- (ii) pretax operating income,
- (iii) earnings before income taxes,
- (iv) earnings before interest, taxes, depreciation and amortization,
- (v) earnings per share,
- (vi) return on shareholders' equity,
- (vii) change in identified expense levels,
- (viii) profitability of an identifiable business unit or product,
- (ix) change in revenues,

(x) stock price appreciation,

(xi) total shareholder return,

any of which or combination of which may be used on an absolute basis or relative to an identified index or peer group as specified by the Committee.

There is an exception to the requirement that the material terms be disclosed and approved by the shareholders if "information that would otherwise be a material term of a performance goal" is confidential business information, the disclosure of which would have an adverse effect on the public company, in the determination of the Committee.ⁿ³⁹ Any such determination must be disclosed and, in any event, both the maximum compensation payable to an individual and the identities or classes of eligible executives must still be disclosed.

In this regard, practitioners should note that, in the Compensation Discussion and Analysis section of their annual disclosure documents registrants are required to disclose how the amount of each element of compensation is determined for each of the named executive officers. The SEC requires registrants to disclose specific performance targets used to determine annual or long-term incentive awards unless the information concerned is a confidential trade secret or confidential commercial or financial information, the disclosure of which would result in competitive harm to the company. Even in that case, registrants are required to discuss how difficult it will be for the executive or how likely it will be for the registrant to achieve the undisclosed target levels.ⁿ⁴⁰ It remains to be seen whether "competitive harm to the company" under the 2006 SEC disclosure regulations is the same as "adverse effect on the publicly held corporation" under the Section 162(m) regulations; one of the factors in the rule-making record before the SEC was the argument, advanced by a number of parties, that companies had abused what they characterized as the non-disclosure loophole in the Section 162(m) regulations and that the SEC should adopt more stringent requirements for disclosure of specific targets used to determine executive compensation.

[iii] Plans Providing for Stock Options or Stock Appreciation Rights, or for Vesting upon Death, Disability or Change in Control

In the case of a plan providing for awards of "at-the-money" stock options or stock appreciation rights, the disclosure of business criteria may be omitted, since the value that grantees derive from such awards is purely a function of stock price appreciation.ⁿ⁴¹ Nevertheless, even in the case of stock options or stock appreciation rights, to be eligible for the Section 162(m) deduction for performance-based compensation the plan must state the maximum number of shares under options or rights that may be granted during a specified period to any employee.ⁿ⁴² With the advent of the SRO rules requiring most equity-based compensation plans to be submitted to and approved by the shareholders,ⁿ⁴³ the issue of disclosure of the terms of equity based plans is essentially moot, since such terms will be disclosed in any event when the plan is submitted to shareholders for approval.

In addition, while the very essence of a Section 162(m) plan is that it provide for payments to be tied to pre-determined performance goals, the plan may also provide for accelerated (and otherwise unconditional) vesting and payment upon death, disability or change in control.ⁿ⁴⁴ Although the plan may contain such a provision without disqualifying the deductibility of performance-based payments made upon the attainment of pre-determined goals, any payments made by reason of death, disability or change-in-control will not be deductible as qualified performance based compensation under Section 162(m).ⁿ⁴⁵

[iv] Disclosure of Compensation Payable Under the Plan

The disclosure of the compensation payable must be sufficiently specific that a shareholder can determine the maximum payout for any given period.ⁿ⁴⁶ If the specific formula is not disclosed, then the dollar maximum payout must be disclosed (and vice versa).ⁿ⁴⁷ Therefore, even in the case of stock options (the economic value of which to the

executive is readily apparent--the spread between the strike price and the market price on the date of exercise), the maximum number of shares that may be granted to any executive and the strike price must be disclosed.ⁿ⁴⁸

[v] *Periodic Re-Approval*

If the compensation committee is authorized to change the targets under a performance goal after initial shareholder approval, the material terms of the performance goal must be disclosed to and re-approved by the shareholders no later than the first shareholder meeting in the fifth year following the year in which shareholders previously approved the performance goal.ⁿ⁴⁹

[c] Step II: Setting the Performance Goals and Making the Grants

It is in the setting of the performance goals that the work of the compensation committee in connection with Section 162(m)-compliant performance-based compensation plans becomes more involved. As a general matter, "[q]ualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals"ⁿ⁵⁰ and it is up to the committee to set those goals at the proper time and in accordance with the required specifications, and to reflect those goals in the necessary documentation.

[i] *Time for Setting of Performance Goals*

A performance goal is considered "preestablished" for Section 162(m) purposes only if it is finally and irrevocably documented no later than 90 days after the commencement of the period of service to which the goal relates and, in any event, no later than by the time 25 percent of the period of service has elapsed.ⁿ⁵¹ In addition, the outcome must be "substantially uncertain" at the time the goal is set.ⁿ⁵² Courts have applied the timing restrictions strictly, with one court going so far as to suggest that performance periods of less than one year are inherently suspect under Section 162(m).ⁿ⁵³

Thus, for example, if the performance goals relate to the current fiscal year (which is also the year of service for which the executive is eligible to earn a performance-based bonus), it must be established by March 30 (a date that is both within the first 90 days and no later than at the end of the first 25 percent of the service period). If the performance period is longer--for example, a three-year cycle under a long-term incentive plan--the goal must still be established by March 30 of the first year. If the service period is shorter than one year, the 25 percent rule will be the gating factor. Thus, for example, in the case of a bonus payable for first-quarter results (an unusual arrangement), then the goal must be established in the first 22.5 days.ⁿ⁵⁴

As far as the substantial uncertainty test, the regulations state, by way of example, that a bonus that is based on a specified percentage of sales is not "substantially uncertain" because the corporation "is virtually certain to have *some* sales for the fiscal year."ⁿ⁵⁵ Yet a bonus that is based on a percentage of profits meets the test (if the performance goal is timely established), since "it is substantially uncertain whether a company will have profits for a specified future period even if a company has a history of profitability."ⁿ⁵⁶

Many other questions can be raised, and have not been addressed in any reported decision, technical advice memorandum or private letter ruling, regarding "substantial uncertainty." For example, this commentator would argue that a goal that the company's stock will be trading at \$10 or higher by a certain date is substantially uncertain even if the stock is trading at \$10 (or even \$12) when the goal is set. Stock prices can go up or down and, as the regulations make clear, a "performance goal need not ...be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion)."ⁿ⁵⁷

[ii] *Criteria for Performance Goals*

Section 162(m)-compliant performance goals must be objective and predetermined, in writing, and sufficiently clear that a third-person looking back at the end of the performance period, with the pertinent performance data in hand, need nothing more than the written record of the original setting of the performance goals and the relevant performance data, which should be available in the normal course (either as part of the company's regular record-keeping or financial reporting or from outside sources), to determine the maximum amount the Named Executive Officers can be paid for that period under the plan. The committee is permitted to exercise "negative discretion" to reduce the award otherwise indicated, but may not have the discretion to increase it.ⁿ⁵⁸ There should be no need for interpretation or subjective judgments of any kind.ⁿ⁵⁹

"Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole A performance goal does not include the mere continued employment of the covered employee."ⁿ⁶⁰ The record of the compensation committee at the time of goal-setting must identify the individual employee or the class of employee entitled to participate in the incentive compensation payments.ⁿ⁶¹

[iii] Discretion

The performance goals must be set in a way that precludes committee discretion to increase the amount of an award indicated by the application of measurable performance results to the pre-determined formula, but the committee may retain the discretion to *decrease* the objectively determined awards.ⁿ⁶² The regulations refer to a permissible exercise of "negative discretion" and this term has come to be used in practice.

If the payment is to be determined as a percentage of salary or base compensation upon the achievement of the pre-determined performance goal, the mere fact that the executive's future compensation, on which the payment will be based, is not determined at the time the goal is set will not disqualify the payment as discretionary under Section 162(m) if the maximum dollar amount to be paid is fixed at that time.ⁿ⁶³

If an incentive payment is to be made immediately upon or at a specified interval after the achievement of a performance goal, any earlier payment must be appropriately discounted or it will be treated as a discretionary increase.ⁿ⁶⁴ Conversely, a delayed payment with interest at a reasonable rate--or with the earnings or losses from pre-determined investments of the principal amount payable according to the pre-determined formula--remains deductible if it otherwise meets the Section 162(m) requirements.ⁿ⁶⁵

Whether the conditions for payment of the compensation meet the requirements of Section 162(m) is determined on a grant-by-grant basis.ⁿ⁶⁶ To qualify for the Section 162(m) deduction, the incentive payment for which the executive is eligible for any given level of performance under the pre-defined performance goals the committee sets must be payable *only* if the specified goal is achieved; that is, the payment must be truly performance-based, with the committee having no discretion to increase the award and with no back-up plan (written, spoken or implied) to pay the compensation (or any part of it) in any event.ⁿ⁶⁷

[iv] Grants of Stock Options and Stock Appreciation Rights

An independent compensation committee's awards of at-the-money stock options or stock appreciation rights ("SARs") are considered inherently performance-based, since the executive does not realize any value under such instruments unless the price of the company's stock appreciates from the time of the grant. Values earned under options or SARs qualify for the Section 162(m) tax deduction as long as the plan specifies the maximum number of shares under options or of rights that may be granted during a specified period to any employee.ⁿ⁶⁸

The regulations are designed to penalize option (or SAR) cancellation and repricing by denying the Section 162(m) "qualified performance-base compensation" deduction to the extent that the total number of options awarded exceed the number authorized under the shareholder-approved plan, *after taking into account all cancelled options*, as well as other

options granted under the plan. Reductions in the exercise price after the initial grant are treated as cancellations and corresponding new grants. After-the-fact reductions in the base price of SARs are treated similarly.ⁿ⁶⁹

[d] Step III: Assessing Performance and Making the Awards

The final step in the process is for the compensation committee to "certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied."ⁿ⁷⁰ As a practical matter, the chief financial officer normally makes a presentation to the board of directors to review actual performance against the pre-established targets. The committee then adopts a resolution certifying that (or the extent to which) the targets were met. Approved committee minutes satisfy the certification requirement. For this purpose, the approved minutes of the compensation committee meeting in which the certification is made are treated as a written certification. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the value of the stock of the publicly held corporation.

[5] Procedures Related to the Stimulus Programs

The Stimulus Programs impose new responsibilities on the compensation committees of participating companies. While guidance remains forthcoming, compensation committees of participating companies must comply with the following requirements:

- (a) Compensation committee must be composed solely of independent directors;ⁿ⁷¹
- (b) The compensation committee must meet at least semi-annually to assess whether compensation arrangements for all employees encourage unnecessary and excessive risk-taking behavior (*i.e.*, whether compensation arrangements incentivize employees to take risks that are unhealthy for the company in order to earn the compensation in question);ⁿ⁷² and
- (c) The compensation committee must certify, in the Compensation Committee Report as required by the SEC, to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC, that it has met with senior risk officials to make sure that compensation does not encourage senior executive officers to take unnecessary risks that threaten the value of the company.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesBusiness Judgment RuleBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewBusiness & Corporate LawCorporationsShareholdersMeetings & VotingAnnual MeetingsTax LawFederal Income Tax ComputationDeductions for Business ExpensesBusiness, Entertainment & Trade Expenses (IRC secs. 162, 274)

FOOTNOTES:

(n1)Footnote 1. *See* Nomad Acquisition Corp. v. Damon Corp., CA 10173, 1988 Del. Ch. LEXIS 133, *17 (Sept. 20, 1988) ("actions of the compensation committee, comprised of Damon's independent directors, are prima facie subject to the protections of the business judgment rule"); *see, e.g.*, Tate & Lyle plc v. Staley Continental, Inc., CA 9813, 1988 Del. Ch. LEXIS 61 (May 9, 1988) (unpublished) (decision to grant golden parachutes and tax gross-ups to company executives protected by the business judgment rule because, among other things, it was made by a compensation committee comprised of disinterested directors); *Kaufman v. Beal*, CA 6485, 1983 Del. Ch. LEXIS 391, *21 (Feb. 25, 1983) (shareholder derivative attacks on allegedly excessive executive compensation were precluded by the business judgment rule where transactions in question were recommended by compensation committee, of which 75 percent of the members were outside directors who received no personal benefit from the transactions in question, and approved

by the board as a whole, a majority of whose members were disinterested).

(n2)Footnote 2. *See* California Public Employee Ret. Sys. v. Coulter, CA 19191, 2002 Del. Ch. LEXIS 144, at *24 (Dec. 18, 2002) . This decision should cause drafters of change-in-control contracts to consider omitting the traditional replacement-of-the-board circumstance from the definition of change in control, at least in companies with classified boards or where the likelihood of a proxy contest is remote.

(n3)Footnote 3. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *89-*91 .

(n4)Footnote 4. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *90-*91 (in view of "considerable scholarly writing" on the good faith concept, including in response to the earlier decisions in the *Disney* case, "some conceptual guidance to the corporate community may be helpful.").

(n5)Footnote 5. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *92 .

(n6)Footnote 6. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *94 ; *see id.* at *94-*95 ("From a broad philosophical standpoint, that question is more complex than would appear, if only because (as the Chancellor and others have observed) 'issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty ... ' ... But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.") (footnotes omitted).

(n7)Footnote 7. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *99 .

(n8)Footnote 8. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *100-*103 .

(n9)Footnote 9. *In re Walt Disney Company Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *103 .

(n10)Footnote 10. *Stone v. Ritter*, No. 93, 2006, 2006 Del. Lexis 597 (DE November 6, 2006), at *19-*20 .

(n11)Footnote 11. *See* Chapter 4 *above* for in-depth discussion of the business judgment rule.

(n12)Footnote 12. *See, e.g.,* Leo E. Strine Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 *Bus. Law.* 1371, 1374-85 (Aug. 2002); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) .

(n13)Footnote 13. *See* Chapter 8 *above*, discussing the Nominating and Corporate Governance Committee.

(n14)Footnote 14. *See* Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations (2002), Part 1, Executive Compensation, Specific Best Practice Suggestion 2, *available at* www.conference-board.org/pdf_free/758.pdf ("The Compensation Committee should be comprised solely of directors who are free of *any* relationships with the company (except for compensation received in their role as directors) and its management and who can act independently of management in carrying out their responsibilities.") (emphasis added).

(n15)Footnote 15. In *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) , in finding that a special litigation committee (the "SLC") was not independent for purposes of dismissal of a shareholders' derivative action, Vice Chancellor Strine took into account a number of connections between the CEO of the defendant corporation and Stanford University, on the one hand; and between Stanford University and each of the otherwise independent members of the two-member SLC (both of whom were Stanford professors, including former SEC commissioner and current

Stanford law professor Joseph Grundfest), on the other hand. It remains to be seen whether the courts will extend this mode of analysis beyond the shareholder-derivative dismissal context but it seems virtually certain that the plaintiffs' bar will continue push for such an extension of the independence doctrine.

(n16)Footnote 16. *See, e.g.*, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 8 ("Board and committee members should resist the tendency to 'go along' for the sake of harmony or to simply rely on the precedents set by others. An effective group dynamic encourages members to speak their minds, examine assumptions, thoroughly discuss the issues, and arrive at appropriate decisions."), 16 ("Each member of the committee should have the resolve and skepticism to ask probing questions, to speak honestly, to set and adhere to necessary limits, to be an advocate for change when a current practice results in the wrong outcome, and to ask 'why'--and if necessary say 'no'--to questionable proposals.") (2003).

(n17)Footnote 17. *See* Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations (2002), Part 1, Executive Compensation, Specific Best Practice Suggestion 8, *available at* www.conference-board.org/pdf_free/757.pdf ("The Compensation Committee should ... exercise its power to schedule meetings and set its own agenda.").

(n18)Footnote 18. *See e.g.*, § 10.04 above and § 10.06[3] below.

(n19)Footnote 19. *See* § 10.06[3] below.

(n20)Footnote 20. Item 404 of Regulation S-K, 17 U.S.C § 229.404, generally requires companies to disclose transactions exceeding \$120,000 in the previous fiscal year in which the issuer was or is to be a participant and in which a "related person" had or will have a direct or indirect material interest. "Related person" is defined to include, among others, any executive officer (not just the named executive officers whose compensation is otherwise required to be disclosed in the proxy statement). Instruction 5.a. to Item 404 provides that "Disclosure of an employment relationship or transaction involving an executive officer and any related compensation solely resulting from that employment relationship or transaction need not be provided pursuant ... if" the compensation is otherwise disclosed under Item 402 (requiring disclosure of compensation of named executive officers) or if "[t]he executive officer is not an immediate family member ... and such compensation would have been reported under Item 402 ... as compensation earned for services to the registrant if the executive officer was a named executive officer ... and such compensation had been approved, or recommended to the board of directors of the registrant for approval, by the compensation committee of the board of directors (or group of independent directors performing a similar function) of the registrant."

(n21)Footnote 21. *See* NASDAQ Rule 5605(d)(31)(A)-(B), Amex Company Guide § 805(a) (in each case, prohibiting CEO to be present during deliberations or voting on his or her compensation).

(n22)Footnote 22. *See* Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations (2002), Part 1, Executive Compensation, Specific Best Practice Suggestion 3, *available at* www.conference-board.org/pdf_free/758.pdf.

(n23)Footnote 23. NYSE Listed Company Manual § 303A.05 Commentary.

(n24)Footnote 24. *See* Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations (2002), Part 1, Executive Compensation, Specific Best Practice Suggestion 1 *available at* www.conference-board.org/pdf_free/758.pdf ("The Compensation Committee should retain any outside consultants who advise it, and the outside consultants should report solely to the Committee.") Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee 4 (2003) ("The consultants should be hired by and report directly to the committee (or the board, if there is no committee), and should not be retained by the company in any other capacity.").

(n25)Footnote 25. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003), discussed at length in §

10.03 above.

(n26)Footnote 26. Complaint, *People of the State of New York v. Grasso*, Index. No. 401620/2004, (filed May 25, 2004), at P 67.

(n27)Footnote 27. See *Section 10.06[5]* for additional information that companies participating in the Stimulus Programs must include in the Compensation Committee Report.

(n28)Footnote 28. It is worth noting that review of the CD&A with management has become especially important given that participants in the Stimulus Programs are already required to give shareholders a non-binding "Say on Pay" vote on a companies compensation program as described in the CD&A. Further, there is at least one piece of pending legislation (S. 1006, 111th Congress) that would extend the requirement for a *binding* "Say on Pay" vote to all public companies for certain "excessive" compensation.

(n29)Footnote 29. Revenues Report to Accompany Recommendations from the Committee on Ways and Means, H.R. Rep. No. 103-111, at 646 (May 25, 1993), *reprinted in* 1993 U.S.C.A.N. 378, 877.

(n30)Footnote 30. *IRC § 162(m)(1)*.

(n31)Footnote 31. See *IRS Notice 2007-49*.

(n32)Footnote 32. *IRC § 162(m)(3)*.

(n33)Footnote 33. *IRC § 162(m)(4)(C)*.

(n34)Footnote 34. For guidance on Section 162(m) audits that the IRS has published for its examiners, see Internal Revenue Service, Section 162(m) Audit Techniques Guide (02-2005), *available at* <http://www.irs.gov/businesses/corporations/article/0,,id=134874,00.html>.

(n35)Footnote 35. *IRC § 162(m)(4)(C)(ii)*; *26 CFR § 1.162.27(e)(4)*.

(n36)Footnote 36. *26 CFR § 1.162.27(e)(4)(i)*.

(n37)Footnote 37. *26 CFR § 1.162.27(e)(4)(ii)*.

(n38)Footnote 38. *26 CFR § 1.162.27(e)(4)(iii)*.

(n39)Footnote 39. *26 CFR § 1.162.27(e)(4)(iii)(B)*.

(n40)Footnote 40. See instruction 4 to item 402(b) of Regulation S-K, *17 CFR 229.402(b)*. In adopting the disclosure requirements, the SEC stated that companies' claims that disclosure of specific targets would cause competitive harm to them should be subject to the same standard that applies when companies request confidential treatment for material filed with the SEC. SEC Release Nos. 33-8732A, 34-54302A, "Executive Compensation and Related Person Disclosure," *71 Fed. Reg. 53158 (Sept. 8, 2006) at 53166-53167*. Such confidential treatment requests are made pursuant to Securities Act Rule 406 (17 CFR § 406) and Exchange Act Rule 24b-2 (*17 CFR § 240.24b-2*), which incorporate the criteria for non-disclosure under Exemption 4 of the Freedom of Information Act, *5 USC § 552(b)(4)*, and Rule 80(b)(4), *17 CFR 200.80(b)(4)* thereunder. In deciding to withhold information on executive compensation targets from the annual disclosure documents, registrants are not required to seek confidential treatment under such procedures if they determine that disclosure would cause competitive harm (but such decisions are subject to challenge by the SEC upon review of such documents).

(n41)Footnote 41. *26 CFR § 1.162.27(e)(4)(iii)(A)*.

(n42)Footnote 42. 26 CFR § 1.162-27(e)(2)(vi).

(n43)Footnote 43. See SEC Releases Nos. 34-48627 (Oct. 14, 2003) (NASDAQ), 34-48610 (Oct. 9, 2003) (Amex), 34-48108 (June 30, 2003) (NYSE & NASDAQ).

(n44)Footnote 44. 26 CFR § 1.162.27(e)(2)(v).

(n45)Footnote 45. In February 2008, in *IRS Revenue Ruling 2008-13*, the IRS clarified (and went back on its earlier position) that compensation cannot be performance-based if it is payable in the event of the covered employee's without cause/good reason termination or voluntary retirement without regard to whether the performance goal is achieved. However, the Revenue Ruling provides important transition relief. In particular, the IRS will not enforce its new position in the following circumstances: (i) the period of service to which the performance goals relate begins on or before January 1, 2009; or (ii) the compensation is paid pursuant to the terms of an employment agreement in effect on February 21, 2008 (without respect to future renewals or extensions, including renewals or extensions that occur automatically absent further action by the employee or the company).

(n46)Footnote 46. 26 CFR § 1.162.27(e)(4)(iv).

(n47)Footnote 47. 26 CFR § 1.162.27(e)(4)(iv).

(n48)Footnote 48. 26 CFR § 1.162.27(e)(4)(iv).

(n49)Footnote 49. 26 CFR § 1.162.27(e)(4)(vi).

(n50)Footnote 50. 26 CFR § 1.162.27(e)(2).

(n51)Footnote 51. See 26 CFR § 1.162.27(e)(2).

(n52)Footnote 52. 26 CFR § 1.162.27(e)(2).

(n53)Footnote 53. *Shaev v. Saper*, No. 02-2206, 2003 U.S. App. Lexis 3272, at *18 (3d Cir. Feb. 21, 2003) ("In the absence of special circumstances, such as when a new company is formed or when an established company changes its fiscal year in good faith, a performance period shorter than one year makes it much less likely that the ... [incentive plan in question] will meet" the Section 162(m) timing requirements.).

(n54)Footnote 54. This author would recommend getting it done by the end of the 22nd day so there is no room for doubt.

(n55)Footnote 55. 26 CFR § 1.162.27(e)(2)(vii), Example 2.

(n56)Footnote 56. 26 CFR § 1.162.27(e)(2)(vii), Example 3. Under the analysis of the substantial uncertainty requirement that some commentators have applied, a \$2 million bonus payable to a major car manufacturer if the company sells at least 1,000 cars should be regarded as substantially uncertain for purposes of Section 162(m). See Kevin J. Ryan, *Note: Rethinking Section 162(m)'s Limitation on the Deduction of Executive Compensation: A Review of the Commentary*, 15 Va. Tax Rev. 371, 386 (1995), citing Jack S. Levin, George B. Javaras, and William R. Welke, *Code Section 162(m)--\$ 1 Million Deduction Limit on Executive Compensation*, 63 Tax Notes 723 (May 9, 1994).

(n57)Footnote 57. 26 CFR § 1.162.27(e)(2)(i).

(n58)Footnote 58. See § 10.06[3][c][iii] below.

(n59)Footnote 59. See 26 CFR § 1.162.27(e)(2)(i) ("A performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal is met.").

(n60)Footnote 60. *26 CFR § 1.162.27(e)(2)(i)*. See also § 15.03[2][b] below, "Choosing the Right Performance Measure."

(n61)Footnote 61. *26 CFR § 1.162.27(e)(2)(ii)*.

(n62)Footnote 62. *26 CFR § 1.162.27(e)(2)(iii)(A)*.

(n63)Footnote 63. *26 CFR § 1.162.27(e)(2)(iii)(A)*.

(n64)Footnote 64. *26 CFR § 1.162.27(2)(iii)*.

(n65)Footnote 65. *26 CFR § 1.162.27(2)(iii)*.

(n66)Footnote 66. *26 CFR § 1.162.27(e)(2)(iv)*.

(n67)Footnote 67. *26 CFR § 1.162.27(e)(2)(v)*.

(n68)Footnote 68. *26 CFR § 1.162.27(e)(2)(vi)(A)*.

(n69)Footnote 69. *26 CFR § 1.162.27(e)(2)(vi)(B)*.

(n70)Footnote 70. *26 CFR § 1.162.27(e)(5)*.

(n71)Footnote 71. It remains unclear whether the independence standards of the SROs will be applied for purposes of the Stimulus Programs. Further, private companies who receive less than \$25 million may satisfy this condition by having the board of directors carry out this duty.

(n72)Footnote 72. A recent SEC proposed rule contemplates an amendment to Item 402 of Regulation S-K to require all companies to discuss and analyze in the Compensation Discussion and Analysis their overall compensation policies and practices for employees generally, including non-executive officers, if the risks arising from the incentives created by these policies and practices could have a material effect on the company as a whole. See SEC Release Nos. 33-9052.

* The authors gratefully acknowledge the assistance of Dina Bernstein, an associate at Gibson, Dunn & Crutcher, with the updates to this chapter.



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Appendix 10-A: Sample Compensation Committee Charter

1-10-A Corporate Governance: Law and Practice Appendix 10-A:.syn

§ 10-A.syn Synopsis to Appendix 10-A: Sample Compensation Committee Charter

[10-A] Sample Compensation Committee Charter



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Appendix 10-A: Sample Compensation Committee Charter

1-10-A Corporate Governance: Law and Practice [10-A]

[10-A] Sample Compensation Committee Charter

1. Members. The Board of Directors of _____ (the "Company") appoints a Compensation Committee of at least three members, consisting entirely of independent directors, and designates one member as chairperson. For purposes hereof, an "independent" director is a director who meets the New York Stock Exchange definition of "independence," as determined by the Board. Additionally, members of the Compensation Committee must qualify as "non-employee directors" for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended, and as "outside directors" for purposes of *Section 162(m) of the Internal Revenue Code*.

2. Purpose, Duties, and Responsibilities. The purpose of the Compensation Committee is to discharge the responsibilities of the Board relating to compensation of the Company's [senior] [executive] officers [and directors] and produce the annual report on executive compensation for inclusion in the Company's proxy statement. The duties and responsibilities of the Compensation Committee are to:

- (a) Oversee the Company's overall compensation structure, policies and programs, and assess whether the Company's compensation structure establishes appropriate incentives for management and employees.
- (b) Administer and make recommendations to the Board with respect to the Company's incentive-compensation and equity-based compensation plans.
- (c) Review and approve corporate goals and objectives relevant to the compensation of the Chief Executive Officer ("CEO"), evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation.
- (d) Set the compensation of other [senior] [executive] officers based upon the recommendation of the CEO.
- (e) Approve stock option and other stock incentive awards for [senior] [executive] officers.
- (f) Review and approve the design of other benefit plans pertaining to [senior] [executive] officers.

- (g) Review and recommend employment agreements and severance arrangements for [senior] [executive] officers, including change-in-control provisions, plans or agreements.
 - (h) Approve, amend or modify the terms of any compensation or benefit plan that does not require shareholder approval.
 - (i) Monitor compliance by [senior] [executive] officers and directors with the Company's stock ownership guidelines. **[If the company has stock ownership guidelines]**
 - (j) Review the compensation of directors for service on the Board and its committees and recommend changes in compensation to the Board. **[This may be done by the Nominating/Governance Committee at some companies, in whole or in part]**
 - (k) Review periodically succession plans relating to positions held by senior [executive] officers, and make recommendations to the Board regarding the selection of individuals to fill these positions.
 - (l) Annually evaluate the performance of the Compensation Committee and the adequacy of the committee's charter.
 - (m) Perform such other duties and responsibilities as are consistent with the purpose of the Compensation Committee and as the Board or the committee deems appropriate.
3. Subcommittees. The Compensation Committee may delegate any of the foregoing duties and responsibilities to a subcommittee of the Compensation Committee consisting of not less than two members of the committee.
4. Outside advisors. The Compensation Committee will have the authority to retain [at the expense of the Company] such outside counsel, experts, and other advisors as it determines appropriate to assist it in the full performance of its functions, [including sole authority to retain and terminate any compensation consultant used to assist the committee in the evaluation of director, CEO or senior executive compensation, and to approve the consultant's fees and other retention terms]. [Note: this is a NYSE suggestion rather than a requirement]
5. Meetings. The Compensation Committee will meet as often as may be deemed necessary or appropriate, in its judgment, either in person or telephonically, and at such times and places as the Compensation Committee determines. The majority of the members of the Compensation Committee constitutes a quorum. The Compensation Committee will report regularly to the full Board with respect to its activities.



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Appendix 10-B: Sample Compensation Committee Self-Assessment Questionnaire and Compliance Checklist *

1-10-B Corporate Governance: Law and Practice Appendix 10-B:.syn

§ 10-B.syn Synopsis to Appendix 10-B: Sample Compensation Committee Self-Assessment Questionnaire and Compliance Checklist *

[10-B] Sample Compensation Committee Self-Assessment Questionnaire and Compliance Checklist



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Appendix 10-B: Sample Compensation Committee Self-Assessment Questionnaire and Compliance Checklist *

1-10-B Corporate Governance: Law and Practice [10-B]

[10-B] Sample Compensation Committee Self-Assessment Questionnaire and Compliance Checklist

Compensation Committee Performance Metrics

[Click here to view image.](#)

COMPENSATION COMMITTEE COMPLIANCE CHECKLISTn*

To be completed by the General Counsel or Corporate Secretary. n**

Check Yes or No; if No, explain.

1. Does the compensation committee have a written charter that meets the proposed listing standards of the New York Stock Exchange?

Yes _____

No _____

2. Is the compensation committee composed entirely of independent directors?

Yes _____

No _____

3. Do all members of the compensation committee meet:

a. U.S. Treasury requirements for independence under Section 162(m) of the tax code, stating that to be tax-deductible as a company expense, compensation of more than \$1 million must be awarded under a compensation plan approved by a compensation committee composed of independent directors, defined as persons who are not current employees, are not former employees who receive pay for prior services, are not

former officers of the company, and do not receive significant remuneration form the company, either directly or indirectly, in any capacity other than as a director?

See Section162(m) of the Internal Revenue Code.

b. New York Stock Exchange standard for independence (pertaining to audit, compensation, and governance committees for listed companies), which specifies, in part, that the director cannot be considered independent unless the board "affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a material relationship with the company)"?

Yes _____

No _____

4. Does the compensation committee annually review and approve the company's goals and objectives for CEO compensation, executive officer compensation, and employment contracts?

See best practices as set forth in "Performance Evaluation of Chief Executive Officers, Boards, and Directors-Report of the NACD Blue Ribbon Commission."

Yes _____

No _____

5. Does the compensation committee, at least once a year, evaluate the CEO's performance in regard to these goals and objectives and then set the CEO's annual compensation, including salary, incentive compensation, and benefits?

Yes _____

No _____

6. Does the compensation committee review the company's incentive-compensation, employee benefit programs, and stock-based plans and, as needed, recommend changes in the plans to the board?

See pertinent regulations under the Employee Retirement Income Security Act of 1974 (ERISA).

Yes _____

No _____

7. Does the compensation committee prepare and publish, in the company's proxy statement, an annual executive compensation report that explains the reasons for its key compensation actions?

Yes _____

No _____

8. Does the compensation committee have the sole authority to retain (and approve fees and set terms for) compensation consultants as the committee deems appropriate?

Yes _____

No _____

9. Does the compensation committee annually conduct an evaluation of its performance and present it to the board?

Yes _____

No _____

10. Are all members of the compensation committee in compliance with the company's code of ethics?

Yes _____

No _____

FOOTNOTES:

(n1)Footnote *. This checklist is based on listing requirements for companies listed on the New York Stock Exchange, Section 303A, including new requirements approved by the SEC on November 4, 2003. See <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>

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(n2)Footnote **. If the committee has its own counsel and/or secretary, then that person can complete the forms.

* Excerpted from the *Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee*, Appendix F "Committee Self-Assessment Tools" (2003). Source: *Governance Policy Workbook*, Director's Handbook Series, NACD, 2003. Copyright © 2003 National Association of Corporate Directors. All rights reserved. Reprinted by permission.



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Appendix 10-C: Regulations Under IRC Section 162(m): 26 CFR § 1.162-27 -- Certain employee remuneration in excess of \$1,000,000

1-10-C Corporate Governance: Law and Practice Appendix 10-C:.syn

§ 10-C.syn Synopsis to Appendix 10-C: Regulations Under IRC Section 162(m): 26 CFR § 1.162-27 -- Certain employee remuneration in excess of \$1,000,000

[10-C] Regulations Under IRC Section 162(m): 26 CFR § 1.162-27 -- Certain employee remuneration in excess of \$1,000,000



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Appendix 10-C: Regulations Under IRC Section 162(m): 26 CFR § 1.162-27 -- Certain employee remuneration in excess of \$1,000,000

1-10-C Corporate Governance: Law and Practice [10-C]

[10-C] Regulations Under IRC Section 162(m): 26 CFR § 1.162-27 -- Certain employee remuneration in excess of \$1,000,000

§ 1.162-27 Certain employee remuneration in excess of \$1,000,000.

(a) Scope. This section provides rules for the application of the \$1 million deduction limit under *Section 162(m) of the Internal Revenue Code*. Paragraph (b) of this section provides the general rule limiting deductions under Section 162(m). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limit for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section 280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to Section 162(m). Paragraph (j) of this section contains the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by Section 162(m) and this section, see section 162(a)(1) and § 1.162-7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1).

(b) Limitation on deduction. Section 162(m) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds \$1,000,000.

(c) Definitions -- (1) Publicly held corporation -- (i) General rule. A publicly held corporation means any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act. A corporation is not considered publicly held if the registration of its equity securities is voluntary. For purposes of this section, whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act.

(ii) Affiliated groups. A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). For purposes of this section, however, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to this section. If a covered employee is paid compensation in a

taxable year by more than one member of an affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the group. Any amount disallowed as a deduction by this section must be prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each such corporation in the taxable year.

(2) Covered employee -- (i) General rule. A covered employee means any individual who, on the last day of the taxable year, is --

(A) The chief executive officer of the corporation or is acting in such capacity; or

(B) Among the four highest compensated officers (other than the chief executive officer).

(ii) Application of rules of the Securities and Exchange Commission. Whether an individual is the chief executive officer described in paragraph (c)(2)(i)(A) of this section or an officer described in paragraph (c)(2)(i)(B) of this section is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

(3) Compensation -- (i) In general. For purposes of the deduction limitation described in paragraph (b) of this section, compensation means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to Section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year.

(ii) Exceptions. Compensation does not include --

(A) Remuneration covered in section 3121(a)(5)(A) through section 3121(a)(5)(D) (concerning remuneration that is not treated as wages for purposes of the Federal Insurance Contributions Act); and

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income. In addition, compensation does not include salary reduction contributions described in section 3121(v)(1).

(4) Compensation Committee. The compensation committee means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish and administer performance goals described in paragraph (e)(2) of this section, and to certify that performance goals are attained, as described in paragraph (e)(5) of this section. A committee of directors is not treated as failing to have the authority to establish performance goals merely because the goals are ratified by the board of directors of the publicly held corporation or, if applicable, any other committee of the board of directors. See paragraph (e)(3) of this section for rules concerning the composition of the compensation committee.

(5) Exchange Act. The Exchange Act means the Securities Exchange Act of 1934.

(6) Examples. This paragraph (c) may be illustrated by the following examples:

Example 1.

Corporation X is a publicly held corporation with a July 1 to June 30 fiscal year. For Corporation X's taxable year ending on June 30, 1995, Corporation X pays compensation of \$2,000,000 to A, an employee. However, A's compensation is not required to be reported to shareholders under the executive compensation disclosure rules of the Exchange Act because A is neither the chief executive officer nor one of the four highest compensated officers employed on the last day of the taxable year. A's compensation is not subject to the deduction limitation of paragraph (b) of this section.

Example 2.

C, a covered employee, performs services and receives compensation from Corporations X, Y, and Z, members of an affiliated group of corporations. Corporation X, the parent corporation, is a publicly held corporation. The total compensation paid to C from all affiliated group members is \$3,000,000 for the taxable year, of which Corporation X pays \$1,500,000; Corporation Y pays \$900,000; and Corporation Z pays \$600,000. Because the compensation paid by all affiliated group members is aggregated for purposes of Section 162(m), \$2,000,000 of the aggregate compensation paid is nondeductible. Corporations X, Y, and Z each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation X has a nondeductible compensation expense of \$1,000,000 ($\$1,500,000 \times \$2,000,000 / \$3,000,000$). Corporation Y has a nondeductible compensation expense of \$600,000 ($\$900,000 \times \$2,000,000 / \$3,000,000$). Corporation Z has a nondeductible compensation expense of \$400,000 ($\$600,000 \times \$2,000,000 / \$3,000,000$).

Example 3.

Corporation W, a calendar year taxpayer, has total assets equal to or exceeding \$5 million and a class of equity security held of record by 500 or more persons on December 31, 1994. However, under the Exchange Act, Corporation W is not required to file a registration statement with respect to that security until April 30, 1995. Thus, Corporation W is not a publicly held corporation on December 31, 1994, but is a publicly held corporation on December 31, 1995.

Example 4.

The facts are the same as in Example 3, except that on December 15, 1996, Corporation W files with the Securities and Exchange Commission to disclose that Corporation W is no longer required to be registered under section 12 of the Exchange Act and to terminate its registration of securities under that provision. Because Corporation W is no longer subject to Exchange Act reporting obligations as of December 31, 1996, Corporation W is not a publicly held corporation for taxable year 1996, even though the registration of Corporation W's securities does not terminate until 90 days after Corporation W files with the Securities and Exchange Commission.

(d) Exception for compensation paid on a commission basis. The deduction limit in paragraph (b) of this section shall not apply to any compensation paid on a commission basis. For this purpose, compensation is paid on a commission basis if the facts and circumstances show that it is paid solely on account of income generated directly by the individual performance of the individual to whom the compensation is paid. Compensation does not fail to be attributable directly to the individual merely because support services, such as secretarial or research services, are utilized in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation does not qualify for the exception provided under this paragraph (d).

(e) Exception for qualified performance-based compensation --

(1) In general. The deduction limit in paragraph (b) of this section does not apply to qualified performance-based compensation. Qualified performance-based compensation is compensation that meets all of the requirements of paragraphs (e)(2) through (e)(5) of this section.

(2) Performance goal requirement -- (i) Preestablished goal. Qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. However, in no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. A performance goal is objective if a third party

having knowledge of the relevant facts could determine whether the goal is met. Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, a vesting provision based solely on continued employment would not constitute a performance goal. See paragraph (e)(2)(vi) of this section for rules on compensation that is based on an increase in the price of stock.

(ii) Objective compensation formula. A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.

(iii) Discretion.

(A) The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary for purposes of this paragraph (e)(2)(iii) merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. However, the exercise of negative discretion with respect to one employee is not permitted to result in an increase in the amount payable to another employee. Thus, for example, in the case of a bonus pool, if the amount payable to each employee is stated in terms of a percentage of the pool, the sum of these individual percentages of the pool is not permitted to exceed 100 percent. If the terms of an objective formula or standard fail to preclude discretion to increase the amount of compensation merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, then the objective formula or standard will not be considered discretionary for purposes of this paragraph (e)(2)(iii) if the maximum dollar amount to be paid is fixed at that time.

(B) If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation, unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment). If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation for purposes of this paragraph (e)(2)(iii). Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.

(C) Compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the requirements of this paragraph (e)(2) to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, or a corporate transaction, such as any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any

separation of a corporation (including a spinoff or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation.

(iv) Grant-by-grant determination. The determination of whether compensation satisfies the requirements of this paragraph (e)(2) generally shall be made on a grant-by-grant basis. Thus, for example, whether compensation attributable to a stock option grant satisfies the requirements of this paragraph (e)(2) generally is determined on the basis of the particular grant made and without regard to the terms of any other option grant, or other grant of compensation, to the same or another employee. As a further example, except as provided in paragraph (e)(2)(vi), whether a grant of restricted stock or other stock-based compensation satisfies the requirements of this paragraph (e)(2) is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under this paragraph (e)(2)(iv) are not performance-based compensation unless they separately satisfy the requirements of this paragraph (e)(2).

(v) Compensation contingent upon attainment of performance goal. Compensation does not satisfy the requirements of this paragraph (e)(2) if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. Thus, if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the grant or award will be considered performance-based. For example, if an employee is entitled to a bonus under either of two arrangements, where payment under a nonperformance-based arrangement is contingent upon the failure to attain the performance goals under an otherwise performance-based arrangement, then neither arrangement provides for compensation that satisfies the requirements of this paragraph (e)(2). Compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of this paragraph (e)(2). As an exception to the general rule set forth in the first sentence of paragraph (e)(2)(iv) of this section, the facts-and-circumstances determination referred to in the first sentence of this paragraph (e)(2)(v) is made taking into account all plans, arrangements, and agreements that provide for compensation to the employee.

(vi) Application of requirements to stock options and stock appreciation rights- (A) In general. Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and, under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award. Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation because it does not satisfy the requirement of this paragraph (e)(2)(vi)(A). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).

(B) Cancellation and repricing. Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of this paragraph (e)(2) to the extent that the number of options granted exceeds the maximum number

of shares for which options may be granted to the employee as specified in the plan. If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. This paragraph (e)(2)(vi)(B) also applies in the case of a stock appreciation right where, after the award is made, the base amount on which stock appreciation is calculated is reduced to reflect a reduction in the fair market value of stock.

(vii) Examples. This paragraph (e)(2) may be illustrated by the following examples:

Example 1.

No later than 90 days after the start of a fiscal year, but while the outcome is substantially uncertain, Corporation S establishes a bonus plan under which A, the chief executive officer, will receive a cash bonus of \$500,000, if year-end corporate sales are increased by at least 5 percent. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to A if, in its judgment, other subjective factors warrant a reduction. The bonus will meet the requirements of this paragraph (e)(2).

Example 2.

The facts are the same as in Example 1, except that the bonus is based on a percentage of Corporation S's total sales for the fiscal year. Because Corporation S is virtually certain to have some sales for the fiscal year, the outcome of the performance goal is not substantially uncertain, and therefore the bonus does not meet the requirements of this paragraph (e)(2).

Example 3.

The facts are the same as in Example 1, except that the bonus is based on a percentage of Corporation S's total profits for the fiscal year. Although some sales are virtually certain for virtually all public companies, it is substantially uncertain whether a company will have profits for a specified future period even if the company has a history of profitability. Therefore, the bonus will meet the requirements of this paragraph (e)(2).

Example 4.

B is the general counsel of Corporation R, which is engaged in patent litigation with Corporation S. Representatives of Corporation S have informally indicated to Corporation R a willingness to settle the litigation for \$50,000,000. Subsequently, the compensation committee of Corporation R agrees to pay B a bonus if B obtains a formal settlement for at least \$50,000,000. The bonus to B does not meet the requirement of this paragraph (e)(2) because the performance goal was not established at a time when the outcome was substantially uncertain.

Example 5.

Corporation S, a public utility, adopts a bonus plan for selected salaried employees that will pay a bonus at the end of a 3-year period of \$750,000 each if, at the end of the 3 years, the price of S stock has increased by 10 percent. The plan also provides that the 10-percent goal will automatically adjust upward or downward by the percentage change in a published utilities index. Thus, for example, if the published utilities index shows a net increase of 5 percent over a 3-year period, then the salaried employees would receive a bonus only if Corporation S stock has increased by 15 percent. Conversely, if the published utilities index shows a net decrease of 5 percent over a 3-year period, then the salaried employees would receive a bonus if Corporation S stock has increased by 5 percent. Because these automatic adjustments in the performance goal are preestablished, the bonus meets the requirement of this paragraph (e)(2), notwithstanding the potential changes in the performance goal.

Example 6.

The facts are the same as in Example 5, except that the bonus plan provides that, at the end of the 3-year period, a bonus of \$750,000 will be paid to each salaried employee if either the price of Corporation S stock has increased by 10 percent or the earnings per share on Corporation S stock have increased by 5 percent. If both the earnings-per-share goal and the stock-price goal are preestablished, the compensation committee's discretion to choose to pay a bonus under either of the two goals does not cause any bonus paid under the plan to fail to meet the requirement of this paragraph (e)(2) because each goal independently meets the requirements of this paragraph (e)(2). The choice to pay under either of the two goals is tantamount to the discretion to choose not to pay under one of the goals, as provided in paragraph (e)(2)(iii) of this section.

Example 7.

Corporation U establishes a bonus plan under which a specified class of employees will participate in a bonus pool if certain preestablished performance goals are attained. The amount of the bonus pool is determined under an objective formula. Under the terms of the bonus plan, the compensation committee retains the discretion to determine the fraction of the bonus pool that each employee may receive. The bonus plan does not satisfy the requirements of this paragraph (e)(2). Although the aggregate amount of the bonus plan is determined under an objective formula, a third party could not determine the amount that any individual could receive under the plan.

Example 8.

The facts are the same as in Example 7, except that the bonus plan provides that a specified share of the bonus pool is payable to each employee, and the total of these shares does not exceed 100% of the pool. The bonus plan satisfies the requirements of this paragraph (e)(2). In addition, the bonus plan will satisfy the requirements of this paragraph (e)(2) even if the compensation committee retains the discretion to reduce the compensation payable to any individual employee, provided that a reduction in the amount of one employee's bonus does not result in an increase in the amount of any other employee's bonus.

Example 9.

Corporation V establishes a stock option plan for salaried employees. The terms of the stock option plan specify that no salaried employee shall receive options for more than 100,000 shares over any 3-year period. The compensation committee grants options for 50,000 shares to each of several salaried employees. The exercise price of each option is equal to or greater than the fair market value at the time of each grant. Compensation attributable to the exercise of the options satisfies the requirements of this paragraph (e)(2). If, however, the terms of the options provide that the exercise price is less than fair market value at the date of grant, no compensation attributable to the exercise of those options satisfies the requirements of this paragraph (e)(2) unless issuance or exercise of the options was contingent upon the attainment of a preestablished performance goal that satisfies this paragraph (e)(2).

Example 10.

The facts are the same as in Example 9, except that, within the same 3-year grant period, the fair market value of Corporation V stock is significantly less than the exercise price of the options. The compensation committee reprices those options to that lower current fair market value of Corporation V stock. The repricing of the options for 50,000 shares held by each salaried employee is treated as the grant of new options for an additional 50,000 shares to each employee. Thus, each of the salaried employees is treated as having received grants for 100,000 shares. Consequently, if any additional options are granted to those employees during the 3-year period, compensation attributable to the exercise of those additional options would not satisfy the requirements of this paragraph (e)(2). The results would be the same if the compensation committee canceled the outstanding options and issued new options to the same employees that were exercisable at the fair market value of Corporation V stock on the date of reissue.

Example 11.

Corporation W maintains a plan under which each participating employee may receive incentive stock options, nonqualified stock options, stock appreciation rights, or grants of restricted Corporation W stock. The plan specifies that each participating employee may receive options, stock appreciation rights, restricted stock, or any combination of each, for no more than 20,000 shares over the life of the plan. The plan provides that stock options may be granted with an exercise price of less than, equal to, or greater than fair market value on the date of grant. Options granted with an exercise price equal to, or greater than, fair market value on the date of grant do not fail to meet the requirements of this paragraph (e)(2) merely because the compensation committee has the discretion to determine the types of awards (i.e., options, rights, or restricted stock) to be granted to each employee or the discretion to issue options or make other compensation awards under the plan that would not meet the requirements of this paragraph (e)(2). Whether an option granted under the plan satisfies the requirements of this paragraph (e)(2) is determined on the basis of the specific terms of the option and without regard to other options or awards under the plan.

Example 12.

Corporation X maintains a plan under which stock appreciation rights may be awarded to key employees. The plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price plus a percentage "gross up" intended to offset the tax liability of the employee. In addition, the plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price, based on the highest price, which is defined as the highest price paid for Corporation X stock (or offered in a tender offer or other arms-length offer) during the 90 days preceding exercise. Compensation attributable to awards under the plan satisfies the requirements of paragraph (e)(2)(vi) of this section, provided that the terms of the plan specify the maximum number of shares for which awards may be made.

Example 13.

Corporation W adopts a plan under which a bonus will be paid to the CEO only if there is a 10% increase in earnings per share during the performance period. The plan provides that earnings per share will be calculated without regard to any change in accounting standards that may be required by the Financial Accounting Standards Board after the goal is established. After the goal is established, such a change in accounting standards occurs. Corporation W's reported earnings, for purposes of determining earnings per share under the plan, are adjusted pursuant to this plan provision to factor out this change in standards. This adjustment will not be considered an exercise of impermissible discretion because it is made pursuant to the plan provision.

Example 14.

Corporation X adopts a performance-based incentive pay plan with a four-year performance period. Bonuses under the plan are scheduled to be paid in the first year after the end of the performance period (year 5). However, in the second year of the performance period, the compensation committee determines that any bonuses payable in year 5 will instead, for bona fide business reasons, be paid in year 10. The compensation committee also determines that any compensation that would have been payable in year 5 will be adjusted to reflect the delay in payment. The adjustment will be based on the greater of the future rate of return of a specified mutual fund that invests in blue chip stocks or of a specified venture capital investment over the five-year deferral period. Each of these investments, considered by itself, is a predetermined actual investment because it is based on the future rate of return of an actual investment. However, the adjustment in this case is not based on predetermined actual investments within the meaning of paragraph (e)(2)(iii)(B) of this section because the amount payable by Corporation X in year 10 will be based on the greater of the two investment returns and, thus, will not be

based on the actual rate of return on either specific investment.

Example 15.

The facts are the same as in Example 14, except that the increase will be based on Moody's Average Corporate Bond Yield over the five-year deferral period. Because this index reflects a reasonable rate of interest, the increase in the compensation payable that is based on the index's rate of return is not considered an impermissible increase in the amount of compensation payable under the formula.

Example 16.

The facts are the same as in Example 14, except that the increase will be based on the rate of return for the Standard & Poor's 500 Index. This index does not measure interest rates and thus does not represent a reasonable rate of interest. In addition, this index does not represent an actual investment. Therefore, any additional compensation payable based on the rate of return of this index will result in an impermissible increase in the amount payable under the formula. If, in contrast, the increase were based on the rate of return of an existing mutual fund that is invested in a manner that seeks to approximate the Standard & Poor's 500 Index, the increase would be based on a predetermined actual investment within the meaning of paragraph (e)(2)(iii)(B) of this section and thus would not result in an impermissible increase in the amount payable under the formula.

(3) Outside directors -- (i) General rule. The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director --

(A) Is not a current employee of the publicly held corporation;

(B) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;

(C) Has not been an officer of the publicly held corporation; and

(D) Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

(ii) Remuneration received. For purposes of this paragraph (e)(3), remuneration is received, directly or indirectly, by a director in each of the following circumstances:

(A) If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the corporation) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

(B) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(C) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(iii) De minimis remuneration- (A) In general. For purposes of paragraphs (e)(3)(ii)(B) and (C) of this section, remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is de minimis if payments to the entity did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within that preceding taxable year of the publicly held corporation.

(B) Remuneration for personal services and substantial owners. Notwithstanding paragraph (e)(3)(iii)(A) of this section, remuneration in excess of \$60,000 is not de minimis if the remuneration is paid to an entity described in paragraph (e)(3)(ii)(B) of this section, or is paid for personal services to an entity described in paragraph (e)(3)(ii)(C) of this section.

(iv) Remuneration for personal services. For purposes of paragraph (e)(3)(iii)(B) of this section, remuneration from a publicly held corporation is for personal services if --

(A) The remuneration is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services (and other similar services that may be specified by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin), performed for the publicly held corporation, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

(B) The director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described in paragraph (e)(3)(iv)(A) of this section to the publicly held corporation, or more than 50 percent of the entity's gross revenues (for the entity's preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

(v) Entity defined. For purposes of this paragraph (e)(3), entity means an organization that is a sole proprietorship, trust, estate, partnership, or corporation. The term also includes an affiliated group of corporations as defined in section 1504 (determined without regard to section 1504(b)) and a group of organizations that would be an affiliated group but for the fact that one or more of the organizations are not incorporated. However, the aggregation rules referred to in the preceding sentence do not apply for purposes of determining whether a director has a beneficial ownership interest of at least 5 percent or greater than 50 percent.

(vi) Employees and former officers. Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. For example, a director of a parent corporation of an affiliated group is not precluded from being an outside director solely because that director is a former officer of an affiliated subsidiary that was spun off or liquidated. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

(vii) Officer. Solely for purposes of this paragraph (e)(3), officer means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties.

(viii) Members of affiliated groups. For purposes of this paragraph (e)(3), the outside directors of the publicly held member of an affiliated group are treated as the outside directors of all members of the affiliated group.

(ix) Examples. This paragraph (e)(3) may be illustrated by the following examples:

Example 1.

Corporations X and Y are members of an affiliated group of corporations as defined in section 1504, until July 1, 1994, when Y is sold to another group. Prior to the sale, A served as an officer of Corporation Y. After July 1, 1994, A is not treated as a former officer of Corporation X by reason of having been an officer of Y.

Example 2.

Corporation Z, a calendar-year taxpayer, uses the services of a law firm by which B is employed, but in which B has a less-than-5-percent ownership interest. The law firm reports income on a July 1 to June 30 basis. Corporation Z appoints B to serve on its compensation committee for calendar year 1998 after determining that, in calendar year 1997, it did not become liable to the law firm for remuneration exceeding the lesser of \$60,000 or five percent of the law firm's gross revenue (calculated for the year ending June 30, 1997). On October 1, 1998, Corporation Z becomes liable to pay remuneration of \$50,000 to the law firm on June 30, 1999. For the year ending June 30, 1998, the law firm's gross revenue was less than \$1 million. Thus, in calendar year 1999, B is not an outside director. However, B may satisfy the requirements for an outside director in calendar year 2000, if, in calendar year 1999, Corporation Z does not become liable to the law firm for additional remuneration. This is because the remuneration actually paid on June 30, 1999 was considered paid on October 1, 1998 under paragraph (e)(3)(ii)(C) of this section.

Example 3.

Corporation Z, a publicly held corporation, purchases goods from Corporation A. D, an executive and less-than-5-percent owner of Corporation A, sits on the board of directors of Corporation Z and on its compensation committee. For 1997, Corporation Z obtains representations to the effect that D is not eligible for any commission for D's sales to Corporation Z and that, for purposes of determining D's compensation for 1997, Corporation A's sales to Corporation Z are not otherwise treated differently than sales to other customers of Corporation A (including its affiliates, if any) or are irrelevant. In addition, Corporation Z has no reason to believe that these representations are inaccurate or that it is otherwise paying remuneration indirectly to D personally. Thus, in 1997, no remuneration is considered paid by Corporation Z indirectly to D personally under paragraph (e)(3)(ii)(A) of this section.

Example 4.

(i) Corporation W, a publicly held corporation, purchases goods from Corporation T. C, an executive and less-than-5-percent owner of Corporation T, sits on the board of directors of Corporation W and on its compensation committee. Corporation T develops a new product and agrees on January 1, 1998 to pay C a bonus of \$500,000 if Corporation W contracts to purchase the product. Even if Corporation W purchases the new product, sales to Corporation W will represent less than 5 percent of Corporation T's gross revenues. In 1999, Corporation W contracts to purchase the new product and, in 2000, C receives the \$500,000 bonus from Corporation T. In 1998, 1999, and 2000, Corporation W does not obtain any representations relating to indirect remuneration to C personally (such as the representations described in Example 3).

(ii) Thus, in 1998, 1999, and 2000, remuneration is considered paid by Corporation W indirectly to C personally under paragraph (e)(3)(ii)(A) of this section. Accordingly, in 1998, 1999, and 2000, C is not an outside director of Corporation W. The result would have been the same if Corporation W had obtained appropriate representations but nevertheless had reason to believe that it was paying remuneration indirectly to C personally.

Example 5.

Corporation R, a publicly held corporation, purchases utility service from Corporation Q, a public utility. The chief executive officer, and less-than-5-percent owner, of Corporation Q is a director of Corporation R. Corporation R pays Corporation Q more than \$60,000 per year for the utility service, but less than 5 percent of Corporation Q's gross revenues. Because utility services are not personal services, the fees paid are not subject to the \$60,000 de minimis rule for remuneration for personal services within the meaning of paragraph (e)(3)(iii)(B) of this section. Thus, the chief executive officer qualifies as an outside director of Corporation R, unless disqualified on some other basis.

Example 6.

Corporation A, a publicly held corporation, purchases management consulting services from Division S of Conglomerate P. The chief financial officer of Division S is a director of Corporation A. Corporation A pays more than \$60,000 per year for the management consulting services, but less than 5 percent of Conglomerate P's gross revenues. Because management consulting services are personal services within the meaning of paragraph (e)(3)(iv)(A) of this section, and the chief financial officer performs significant services for Division S, the fees paid are subject to the \$60,000 de minimis rule as remuneration for personal services. Thus, the chief financial officer does not qualify as an outside director of Corporation A.

Example 7.

The facts are the same as in Example 6, except that the chief executive officer, and less-than-5-percent owner, of the parent company of Conglomerate P is a director of Corporation A and does not perform significant services for Division S. If the gross revenues of Division S do not constitute more than 50 percent of the gross revenues of Conglomerate P for P's preceding taxable year, the chief executive officer will qualify as an outside director of Corporation A, unless disqualified on some other basis.

(4) Shareholder approval requirement -- (i) General rule. The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The requirements of this paragraph (e)(4) are not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. The material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).

(ii) Eligible employees. Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient, such as the chief executive officer and vice presidents, or all salaried employees, all executive officers, or all key employees.

(iii) Description of business criteria- (A) In general. Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is no less than current fair market value.

(B) Disclosure of confidential information. The requirements of this paragraph (e)(4) may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders, provided

that the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Whether disclosure would adversely affect the corporation is determined on the basis of the facts and circumstances. If the compensation committee makes such a determination, the disclosure to shareholders must state the compensation committee's belief that the information is confidential commercial or business information, the disclosure of which would adversely affect the company. In addition, the ability not to disclose confidential information does not eliminate the requirement that disclosure be made of the maximum amount of compensation that is payable to an individual under a performance goal. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

(iv) Description of compensation. Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (e.g., fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

(v) Disclosure requirements of the Securities and Exchange Commission. To the extent not otherwise specifically provided in this paragraph (e)(4), whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Exchange Act.

(vi) Frequency of disclosure. Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.

(vii) Shareholder vote. For purposes of this paragraph (e)(4), the material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.

(viii) Members of affiliated group. For purposes of this paragraph (e)(4), the shareholders of the publicly held member of the affiliated group are treated as the shareholders of all members of the affiliated group.

(ix) Examples. This paragraph (e)(4) may be illustrated by the following examples:

Example 1.

Corporation X adopts a plan that will pay a specified class of its executives an annual cash bonus based on the overall increase in corporate sales during the year. Under the terms of the plan, the cash bonus of each executive equals \$100,000 multiplied by the number of percentage points by which sales increase in the current year when compared to the prior year. Corporation X discloses to its shareholders prior to the vote both the class of executives eligible to receive awards and the annual formula of \$100,000 multiplied by the percentage increase in sales. This disclosure meets the requirements of this paragraph (e)(4). Because the compensation committee does not have the authority to establish a different target under the plan, Corporation X need not redisclose to its shareholders and obtain their reapproval of the material terms of the plan until those material terms are changed.

Example 2.

The facts are the same as in Example 1 except that Corporation X discloses only that bonuses will be paid on the basis of the annual increase in sales. This disclosure does not meet the requirements of this paragraph (e)(4) because it does not include the formula for calculating the compensation or a maximum amount of compensation to be paid if the performance goal is satisfied.

Example 3.

Corporation Y adopts an incentive compensation plan in 1995 that will pay a specified class of its executives a bonus every 3 years based on the following 3 factors: increases in earnings per share, reduction in costs for specified divisions, and increases in sales by specified divisions. The bonus is payable in cash or in Corporation Y stock, at the option of the executive. Under the terms of the plan, prior to the beginning of each 3-year period, the compensation committee determines the specific targets under each of the three factors (i.e., the amount of the increase in earnings per share, the reduction in costs, and the amount of sales) that must be met in order for the executives to receive a bonus. Under the terms of the plan, the compensation committee retains the discretion to determine whether a bonus will be paid under any one of the goals. The terms of the plan also specify that no executive may receive a bonus in excess of \$1,500,000 for any 3-year period. To satisfy the requirements of this paragraph (e)(4), Corporation Y obtains shareholder approval of the plan at its 1995 annual shareholder meeting. In the proxy statement issued to shareholders, Corporation Y need not disclose to shareholders the specific targets that are set by the compensation committee. However, Corporation Y must disclose that bonuses are paid on the basis of earnings per share, reductions in costs, and increases in sales of specified divisions. Corporation Y also must disclose the maximum amount of compensation that any executive may receive under the plan is \$1,500,000 per 3-year period. Unless changes in the material terms of the plan are made earlier, Corporation Y need not disclose the material terms of the plan to the shareholders and obtain their reapproval until the first shareholders' meeting held in 2000.

Example 4.

The same facts as in Example 3, except that prior to the beginning of the second 3-year period, the compensation committee determines that different targets will be set under the plan for that period with regard to all three of the performance criteria (i.e., earnings per share, reductions in costs, and increases in sales). In addition, the compensation committee raises the maximum dollar amount that can be paid under the plan for a 3-year period to \$2,000,000. The increase in the maximum dollar amount of compensation under the plan is a changed material term. Thus, to satisfy the requirements of this paragraph (e)(4), Corporation Y must disclose to and obtain approval by the shareholders of the plan as amended.

Example 5.

In 1998, Corporation Z establishes a plan under which a specified group of executives will receive a cash bonus not to exceed \$750,000 each if a new product that has been in development is completed and ready for sale to customers by January 1, 2000. Although the completion of the new product is a material term of the performance goal under this paragraph (e)(4), the compensation committee determines that the disclosure to shareholders of the performance goal would adversely affect Corporation Z because its competitors would be made aware of the existence and timing of its new product. In this case, the requirements of this paragraph (e)(4) are satisfied if all other material terms, including the maximum amount of compensation, are disclosed and the disclosure affirmatively states that the terms of the performance goal are not being disclosed because the compensation committee has determined that those terms include confidential information, the disclosure of which would adversely affect Corporation Z.

(5) Compensation committee certification. The compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. For this purpose, approved

minutes of the compensation committee meeting in which the certification is made are treated as a written certification. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the value of the stock of the publicly held corporation.

(f) Companies that become publicly held, spinoffs, and similar transactions -- (1) In general. In the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, the deduction limit of paragraph (b) of this section does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held. However, in the case of such a corporation that becomes publicly held in connection with an initial public offering, this relief applies only to the extent that the prospectus accompanying the initial public offering disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. In accordance with paragraph (c)(1)(ii) of this section, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this paragraph (f)(1).

(2) Reliance period. Paragraph (f)(1) of this section may be relied upon until the earliest of --

(i) The expiration of the plan or agreement;

(ii) The material modification of the plan or agreement, within the meaning of paragraph (h)(1)(iii) of this section;

(iii) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(iv) The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering occurs or, in the case of a privately held corporation that becomes publicly held without an initial public offering, the first calendar year following the calendar year in which the corporation becomes publicly held.

(3) Stock-based compensation. Paragraph (f)(1) of this section will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (f)(1) of this section if the grant occurs on or before the earliest of the events specified in paragraph (f)(2) of this section.

(4) Subsidiaries that become separate publicly held corporations -- (i) In general. If a subsidiary that is a member of the affiliated group described in paragraph (c)(1)(ii) of this section becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation described in paragraph (e) of this section if the conditions in either paragraph (f)(4)(ii) or (f)(4)(iii) of this section are satisfied.

(ii) Prior establishment and approval. Remuneration satisfies the requirements of this paragraph (f)(4)(ii) if the remuneration satisfies the requirements for performance-based compensation set forth in paragraphs (e)(2), (e)(3), and (e)(4) of this section (by application of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) before the corporation becomes a separate publicly held corporation, and the certification required by paragraph (e)(5) of this section is made by the compensation committee of the new publicly held corporation (but if the performance goals are attained before the corporation becomes a separate publicly held corporation, the certification may be made by the compensation committee referred to in paragraph (e)(3)(viii) of this section before it becomes a separate publicly held corporation). Thus, this paragraph (f)(4)(ii) requires that the outside directors and shareholders (within the meaning of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) of the corporation before it becomes a separate publicly held corporation establish and approve, respectively, the performance-based compensation for the covered employees of the new publicly held corporation in accordance with paragraphs (e)(3) and (e)(4) of this section.

(iii) Transition period. Remuneration satisfies the requirements of this paragraph (f)(4)(iii) if the remuneration satisfies all of the requirements of paragraphs (e)(2), (e)(3), and (e)(5) of this section. The outside directors (within the meaning of paragraph (e)(3)(viii) of this section) of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements of paragraphs (e)(2) and (e)(3) of this section. The certification required by paragraph (e)(5) of this section must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on this paragraph (f)(4)(iii) to satisfy the requirements of paragraph (e) of this section only for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Compensation paid, or stock options, stock appreciation rights, or restricted property granted, on or after the date of that meeting of shareholders must satisfy all requirements of paragraph (e) of this section, including the shareholder approval requirement of paragraph (e)(4) of this section, in order to satisfy the requirements for performance-based compensation.

(5) Example. The following example illustrates the application of paragraph (f)(4)(ii) of this section:

Example. Corporation P, which is publicly held, decides to spin off Corporation S, a wholly owned subsidiary of Corporation P. After the spinoff, Corporation S will be a separate publicly held corporation. Before the spinoff, the compensation committee of Corporation P, pursuant to paragraph (e)(3)(viii) of this section, establishes a bonus plan for the executives of Corporation S that provides for bonuses payable after the spinoff and that satisfies the requirements of paragraph (e)(2) of this section. If, pursuant to paragraph (e)(4)(viii) of this section, the shareholders of Corporation P approve the plan prior to the spinoff, that approval will satisfy the requirements of paragraph (e)(4) of this section with respect to compensation paid pursuant to the bonus plan after the spinoff. However, the compensation committee of Corporation S will be required to certify that the goals are satisfied prior to the payment of the bonuses in order for the bonuses to be considered performance-based compensation.

(g) Coordination with disallowed excess parachute payments. The \$1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays \$1,500,000 to a covered employee and no portion satisfies the exception in paragraph (d) of this section for commissions or paragraph (e) of this section for qualified performance-based compensation. Of the \$1,500,000, \$600,000 is an excess parachute payment, as defined in section 280G(b)(1) and is disallowed by reason of that section. Because the excess parachute payment reduces the limitation of paragraph (b) of this section, the corporation can deduct \$400,000, and \$500,000 of the otherwise deductible amount is nondeductible by reason of Section 162(m).

(h) Transition rules -- (1) Compensation payable under a written binding contract which was in effect on February 17, 1993- (i) General rule. The deduction limit of paragraph (b) of this section does not apply to any compensation payable under a written binding contract that was in effect on February 17, 1993. The preceding sentence does not apply unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services. However, the deduction limit of paragraph (b) of this section does apply to a contract that is renewed after February 17, 1993. A written binding contract that is terminable or cancelable by the corporation after February 17, 1993, without the employee's consent is treated as a new contract as of the date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed as of a certain date unless either the corporation or the employee gives notice of termination of the contract at least 30 days before that date, the contract is treated as a new contract as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date. Alternatively, if the corporation will remain legally obligated by the terms of

a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee.

(ii) Compensation payable under a plan or arrangement. If a compensation plan or arrangement meets the requirements of paragraph (h)(1)(i) of this section, the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit of paragraph (b) of this section even though the employee was not eligible to participate in the plan as of February 17, 1993. However, the preceding sentence does not apply unless the employee was employed on February 17, 1993, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iii) Material modifications.

(A) Paragraph (h)(1)(i) of this section will not apply to any written binding contract that is materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract prior to a material modification are not affected, but amounts received subsequent to the material modification are not treated as paid under a binding, written contract described in paragraph (h)(1)(i) of this section.

(B) A modification of the contract that accelerates the payment of compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment).

(C) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding, written contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, a supplemental payment of compensation that satisfies the requirements of qualified performance-based compensation in paragraph (e) of this section will not be treated as a material modification.

(iv) Examples. The following examples illustrate the exception of this paragraph (h)(1):

Example 1.

Corporation X executed a 3-year compensation arrangement with C on February 15, 1993, that constitutes a written binding contract under applicable state law. The terms of the arrangement provide for automatic extension after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the arrangement within 30 days of the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the compensation arrangement does not require the termination of C's employment relationship with Corporation X. Unless terminated, the arrangement is treated as renewed on February 15, 1996, and the deduction limit of paragraph (b) of this section applies to payments under the arrangement after that date.

Example 2.

Corporation Y executed a 5-year employment agreement with B on January 1, 1992, providing for a salary of \$900,000 per year. Assume that this agreement constitutes a written binding contract under applicable state law. In 1992 and 1993, B receives the salary of \$900,000 per year. In 1994, Corporation Y increases B's salary with a payment of \$20,000. The \$20,000 supplemental payment does not constitute a material modification of the written binding contract because the \$20,000 payment is less than or equal to a reasonable cost-of-living increase from 1993. However, the \$20,000 supplemental payment is subject to the limitation in paragraph (b) of this section. On January 1, 1995, Corporation Y increases B's salary to \$1,200,000. The \$280,000 supplemental payment is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract and it is greater than a reasonable, annual cost-of-living increase. Because the written binding contract is materially modified as of January 1, 1995, all compensation paid to B in 1995 and thereafter is subject to the deduction limitation of Section 162(m).

Example 3.

Assume the same facts as in Example 2, except that instead of an increase in salary, B receives a restricted stock grant subject to B's continued employment for the balance of the contract. The restricted stock grant is not a material modification of the binding written contract because any additional compensation paid to B under the grant is not paid on the basis of substantially the same elements and conditions as B's salary because it is based both on the stock price and B's continued service. However, compensation attributable to the restricted stock grant is subject to the deduction limitation of Section 162(m).

(2) Special transition rule for outside directors. A director who is a disinterested director is treated as satisfying the requirements of an outside director under paragraph (e)(3) of this section until the first meeting of shareholders at which directors are to be elected that occurs on or after January 1, 1996. For purposes of this paragraph (h)(2) and paragraph (h)(3) of this section, a director is a disinterested director if the director is disinterested within the meaning of Rule 16b-3(c)(2)(i), *17 CFR 240.16b-3(c)(2)(i)*, under the Exchange Act (including the provisions of Rule 16b-3(d)(3), as in effect on April 30, 1991).

(3) Special transition rule for previously-approved plans -- (i) In general. Any compensation paid under a plan or agreement approved by shareholders before December 20, 1993, is treated as satisfying the requirements of paragraphs (e)(3) and (e)(4) of this section, provided that the directors administering the plan or agreement are disinterested directors and the plan was approved by shareholders in a manner consistent with Rule 16b-3(b), *17 CFR 240.16b-3(b)*, under the Exchange Act or Rule 16b-3(a), *17 CFR 240.16b-3(a)* (as contained in 17 CFR part 240 revised April 1, 1990). In addition, for purposes of satisfying the requirements of paragraph (e)(2)(vi) of this section, a plan or agreement is treated as stating a maximum number of shares with respect to which an option or right may be granted to any employee if the plan or agreement that was approved by the shareholders provided for an aggregate limit, consistent with Rule 16b-3(b), *17 CFR 250.16b-3(b)*, on the shares of employer stock with respect to which awards may be made under the plan or agreement.

(ii) Reliance period. The transition rule provided in this paragraph (h)(3) shall continue and may be relied upon until the earliest of --

(A) The expiration or material modification of the plan or agreement;

(B) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(C) The first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996.

(iii) Stock-based compensation. This paragraph (h)(3) will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (h)(3)(i) of this section if the grant occurs on or before the earliest of the events specified in paragraph (h)(3)(ii) of this section.

(iv) Example. The following example illustrates the application of this paragraph (h)(3):

Example. Corporation Z adopted a stock option plan in 1991. Pursuant to Rule 16b-3 under the Exchange Act, the stock option plan has been administered by disinterested directors and was approved by Corporation Z shareholders. Under the terms of the plan, shareholder approval is not required again until 2001. In addition, the terms of the stock option plan include an aggregate limit on the number of shares available under the plan. Option grants under the Corporation Z plan are made with an exercise price equal to or greater than the fair market value of Corporation Z stock. Compensation attributable to the exercise of options that are granted under the plan before the earliest of the dates specified in paragraph (h)(3)(ii) of this section will be treated as satisfying the requirements of paragraph (e) of this section for qualified performance-based compensation, regardless of when the options are exercised.

(i) (Reserved)

(j) Effective date -- (1) In general. Section 162(m) and this section apply to compensation that is otherwise deductible by the corporation in a taxable year beginning on or after January 1, 1994.

(2) Delayed effective date for certain provisions -- (i) Date on which remuneration is considered paid. Notwithstanding paragraph (j)(1) of this section, the rules in the second sentence of each of paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section for determining the date or dates on which remuneration is considered paid to a director are effective for taxable years beginning on or after January 1, 1995. Prior to those taxable years, taxpayers must follow the rules in paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section or another reasonable, good faith interpretation of Section 162(m) with respect to the date or dates on which remuneration is considered paid to a director.

(ii) Separate treatment of publicly held subsidiaries. Notwithstanding paragraph (j)(1) of this section, the rule in paragraph (c)(1)(ii) of this section that treats publicly held subsidiaries as separately subject to Section 162(m) is effective as of the first regularly scheduled meeting of the shareholders of the publicly held subsidiary that occurs more than 12 months after December 2, 1994. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for this purpose, except that the grant must occur before the shareholder meeting specified in this paragraph (j)(2)(ii). Taxpayers may choose to rely on the rule referred to in the first sentence of this paragraph (j)(2)(ii) for the period prior to the effective date of the rule.

(iii) Subsidiaries that become separate publicly held corporations. Notwithstanding paragraph (j)(1) of this section, if a subsidiary of a publicly held corporation becomes a separate publicly held corporation as described in paragraph (f)(4)(i) of this section, then, for the duration of the reliance period described in paragraph (f)(2) of this section, the rules of paragraph (f)(1) of this section are treated as applying (and the rules of paragraph (f)(4) of this section do not apply) to remuneration paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, provided that the treatment of that remuneration as performance-based is in accordance with a reasonable, good faith interpretation of Section 162(m). However, if remuneration is paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, but that remuneration is not performance-based under a reasonable, good faith interpretation of Section 162(m), the rules of paragraph (f)(1) of this section will be treated as applying only until the first regularly scheduled meeting of shareholders that occurs more than 12 months after December 2, 1994. The rules of paragraph (f)(4) of this section will apply as of that first regularly scheduled meeting. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for purposes of this paragraph (j)(2)(iii), except that the grant must occur before the shareholder

meeting specified in the preceding sentence if the remuneration is not performance-based under a reasonable, good faith interpretation of Section 162(m). Taxpayers may choose to rely on the rules of paragraph (f)(4) of this section for the period prior to the applicable effective date referred to in the first or second sentence of this paragraph (j)(2)(iii).

(iv) Bonus pools. Notwithstanding paragraph (j)(1) of this section, the rules in paragraph (e)(2)(iii)(A) that limit the sum of individual percentages of a bonus pool to 100 percent will not apply to remuneration paid before January 1, 2001, based on performance in any performance period that began prior to December 20, 1995.

(v) Compensation based on a percentage of salary or base pay. Notwithstanding paragraph (j)(1) of this section, the requirement in paragraph (e)(4)(i) of this section that, in the case of certain formulas based on a percentage of salary or base pay, a corporation disclose to shareholders the maximum dollar amount of compensation that could be paid to the employee, will apply only to plans approved by shareholders after April 30, 1995.



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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

1-11 Corporate Governance: Law and Practice 11.syn

AUTHOR: S. Mark Hurd Andrew M. Johnston

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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

1-11 Corporate Governance: Law and Practice § 11.01

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§ 11.01 Introduction: Special Committee Purposes

Other chapters in this volume deal with standing committees of the board of directors, such as the audit and compensation committees.ⁿ¹ These committees have important roles and, although their authority and responsibilities may change over time, they remain as committees of the board, year after year. Occasionally, a "special" situation may arise that calls for the formation of a "special" committee. Although the responsibility for one of these "special" situations can be (and sometimes is) lodged with a standing committee, more frequently a new committee, formed to deal solely with the "special" situation, is created.

This chapter deals with two frequently used "special" committees--the special negotiating committee ("SNC") and the special litigation committee ("SLC").ⁿ² As the name implies, SNCs are formed to negotiate a particular transaction, typically one with or involving a corporate insider such as the CEO, a director or a significant stockholder. As will be discussed in this chapter, "negotiate" will often include decisions relating to whether to proceed with a transaction at all. An SLC wrestles with whether the corporation should pursue claims against a director or officer by someone (most often a stockholder) who contends that such claim should be brought.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion

FOOTNOTES:

(n1)Footnote 1. *See* Chapters 9 and 10 *above*.

(n2)Footnote 2. Other "special" committees are sometimes necessary. For instance, a board may form a special committee to investigate allegations of wrongdoing or irregularities within the corporation.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.02

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§ 11.02 Why Have a Special Negotiating Committee?

An SNC is established to deal with a proposed transaction between or involving the corporation and one or more of the corporation's directors, senior officers or stockholders. Because of the relationship the directors, officers or stockholders have to the corporation, the transaction may have the appearance (or the reality) of a conflict of interest transaction. Illustrative is the Delaware Supreme Court's opinion in *Weinberger v. UOP Inc.*,ⁿ¹ a seminal case in the SNC area. The Delaware Supreme Court reviewed a proposed merger transaction between UOP, Inc. and its majority stockholder parent. The court found that the parent had conducted itself in such a way in the transaction that the burden of proof in the litigation would be on the parent to prove that the transaction was entirely fair to the minority stockholders of UOP. In its discussion of the legal standard, the court noted in a footnote that:

Although perfection is not possible, or expected, the result would have been entirely different if [the subsidiary] had appointed an independent negotiating committee of its outside directors to deal with [parent] at arm's length. [citation omitted]. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered or pursued. [citation omitted]. Particularly in a parent-subsiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness. [citation omitted].ⁿ²

The precise effect of the approval of a transaction by an SNC comprised of independent directors is discussed in more detail below. However, as a general matter, the approval of a transaction by an SNC will result in a transaction that is much more likely to be sustained in the face of a judicial challenge.

[1] Alternatives to a Special Negotiating Committee

[a] Board Action

There are alternatives to an SNC. First, in a situation where a majority of the members of the board are independent and disinterested, the board, rather than a committee, can act with respect to a conflict transaction, if it does so in a

deliberate, informed manner.ⁿ³ Of course, the court will expect the board to have an active role in the consideration and negotiation of the transaction, particularly if a person with conflicting interests has significant involvement in the transaction. For instance, in *Alidina*, plaintiffs alleged that, as part of a sale of the Company, the CEO to whom the board had delegated the negotiation of the sale, also negotiated the sale to himself of a corporate asset at a price that was unfair to the corporation. In addressing the plaintiff's contention that the board had a duty to form a special committee, the court said:

Plaintiffs contend that the board breached its duty of care by yielding to [the CEO's] negotiations, by not using a special committee, and by not appropriately educating itself on the value of [corporate asset sold to the CEO]. Here, the board was admittedly not self-interested. It was within the board's business judgment to delegate the negotiation of the Transactions to its CEO. There is nothing inherently wrong with allowing an interested CEO to negotiate a transaction. [footnote omitted]. What does matter is whether the directors sufficiently oversee such negotiations by scrutinizing the resulting transaction in order to assure themselves that it is fair to the shareholders and to the company. There is no automatic requirement that the board employ a special committee to perform this evaluation, especially when a majority of the board is disinterested and independent. Here, the board considered whether a special committee was needed and explicitly found that one was not. This is a valid exercise of the board's business judgment. Therefore, the only questions remaining are whether the board was informed and whether its decision was based on a rational business purpose.ⁿ⁴

The court ultimately concluded that the board, having put the CEO in charge of the negotiations, did not do enough to monitor, and inform itself concerning, the results of the negotiations given the CEO's differing roles and interests.

[b] Minority Stockholder Approval

Case law makes clear that approval of a transaction involving a majority stockholder by a majority of the minority stockholders will have the same effect as approval by an SNC.ⁿ⁵

[c] Choosing Among the Alternatives

Each of the alternatives will have advantages in a particular circumstance. For instance, as discussed later in this chapter, the question of the independence of the members of a board of directors can be intensely factual and it may not be entirely clear that a corporation has any independent directors to serve on an SNC. In such a situation, the vote of a majority of the disinterested stockholders will provide greater certainty that, if the transaction is approved, it will be reviewed under the most beneficial legal standard attainable. By contrast, if a transaction does not otherwise require a stockholder vote,ⁿ⁶ use of an SNC can avoid the cost, expense and delay associated with seeking and obtaining stockholder approval.

In many situations, an SNC is preferable to a stockholder vote for a variety of practical reasons. First, from the perspective of the conflicted fiduciary (such as a majority stockholder), an SNC may be preferable because the majority stockholder will have somebody with whom to negotiate. In this way, the majority stockholder will be able to decide much sooner in the transaction whether it will be able to reach acceptable terms. In a situation involving a stockholder vote, it is much more difficult for the interested party to know how to get to the point of having a transaction it can present to the stockholders: with whom should it negotiate? how should it conduct the negotiations? As a result, there is a greater potential in a stockholder vote situation than in an SNC scenario that the interested party can spend a great deal of time and resources without knowing until the very late stages whether the transaction will be approved.

[2] Legal Principles Applicable to a Special Negotiating Committee

To understand the effect of the approval of a transaction by an SNC in various circumstances, it is necessary first to understand several general principles.

[a] Business Judgment Rule

A decision by a board of directors in which the directors have no direct or indirect personal interest, which is based upon all reasonably available material information and after careful consideration of alternatives and which is in the good faith furtherance of some identifiable corporate purpose, will not be interfered with by the courts or result in the imposition of liability for damages upon the directors, even if the decision later appears to have been unwise or to have caused harm to the corporation.ⁿ⁷ This is the so-called "business judgment rule."

A related concept is the business judgment presumption, which provides that if a decision of directors is challenged, it will be presumed that the directors satisfied their fiduciary duties and hence, for a plaintiff to obtain relief, such as enjoining the transaction or holding the directors personally liable for damages resulting from the decision, the plaintiff must rebut the presumption by alleging facts which, if true, would support liability.ⁿ⁸

[b] Directorial Duties

One way for a plaintiff to overcome the business rule presumption is to allege (and ultimately prove) facts that support the conclusion that the directors breached their fiduciary duties. These duties are, in general, the duties of care and loyalty.ⁿ⁹ In the context of deciding whether to approve a transaction, the fiduciary duty of care requires the directors "inform themselves, prior to making a business decision, of all material information reasonably available to them."ⁿ¹⁰ The duty of loyalty, requires that directors make decisions based on what is in the best interest of the corporation and its shareholders, free of any extraneous considerations. In the SNC context, the duty of loyalty is most often implicated.

[c] Fairness Standard

If a plaintiff is able to overcome the business judgment rule presumption by, for instance, pleading facts that demonstrate that a majority of the directors were interested in the particular transaction that was approved by the board of directors, the directors, to avoid liability, will have to prove that the transaction is "fair."ⁿ¹¹ Fairness is a broad-ranging, fact-intensive concept that has to do both with the economic or financial result achieved and the process by which it was achieved.ⁿ¹²

The Delaware courts have recognized that the burden of proving fairness is a difficult one and that the determination of which standard--fairness or the business judgment rule--applies in a particular context can be outcome determinative. As stated by the Delaware Supreme Court:

It is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies. It is sometimes thought that the decision whether to apply the business judgment rule or the entire fairness test can be outcome determinative.

[B]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness is so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.ⁿ¹³

Although there have been cases in which courts have sustained a transaction as fair,ⁿ¹⁴ in general, well-advised business people do not want to plan to have to prove fairness in planning a transaction because "the doctrine of entire fairness does not lend itself to bright line precision or a rigid doctrine."ⁿ¹⁵

This is where the SNC comes into play. Depending on the type of transaction that is at issue and the parties to that transaction, approval of the transaction by an SNC can be substantial evidence of fairness, can shift the burden of proving unfairness to the plaintiff, or may result in a shift in the burden of proof from a fairness standard to the business judgment rule standard. Several identifiable types of transactions and the legal standard applicable to that type of transaction are discussed below.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesBusiness Judgment RuleBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesRatificationBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesFiduciary ResponsibilitiesGeneral Overview

FOOTNOTES:

(n1)Footnote 1. *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983) .

(n2)Footnote 2. *Weinberger*, 457 A.2d at 709 n.7 .

(n3)Footnote 3. *Alidina*, 2002 Del. Ch. LEXIS 156 .

(n4)Footnote 4. *Alidina*, 2002 Del. Ch. LEXIS 156, at *22-23 .

(n5)Footnote 5. *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1117 (Del. 1994) .

(n6)Footnote 6. In general, stockholder approval is required as a matter of state law to authorize a merger effected under Section 251 of the Delaware General Corporation Law, a sale, lease or exchange of all or substantially all of the assets of a Delaware corporation (*Del. Code Ann. tit. 8, § 271*), to amend the certificate of incorporation of the corporation (*Del. Code Ann. tit. 8, § 242*) or to dissolve the corporation (*Del. Code Ann. tit. 8, § 275*). Stock exchange rules may also require stockholder approval of the issuance of stock by the listed corporation, typically exceeding 20 percent of the outstanding stock of the corporation. For instance, Section 312.03(c) of the Rules of the New York Stock Exchange requires shareholder approval prior to the issuance by a corporation, the shares of which are listed on the New York Stock Exchange of common stock or securities convertible into common stock, if the stock has or will have upon issuance voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance.

(n7)Footnote 7. Drexler et al., *Delaware Corporation Law and Practice*, §15.03 (LexisNexis Matthew Bender).

(n8)Footnote 8. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) . See also Drexler et al., *Delaware Corporation Law and Practice*, §15.04 (LexisNexis Matthew Bender).

(n9)Footnote 9. The Delaware Supreme Court has also articulated a fiduciary duty of "good faith." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) . One Vice Chancellor has described the duty of good faith as "a subset of a director's duty of loyalty," *Orman v. Cullman*, 794 A.2d 5, 14 n.3 (Del. Ch., 2002). The Delaware Supreme Court has described the duty so as to suggest an element of "recklessness," stating that an "intentional dereliction of duty, a conscious disregard for one's responsibilities" would constitute bad faith. *In re the Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 66 (Del. 2006) .

(n10)Footnote 10. *California Pub. Employees' Ret. Sys. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144, at *34 (Dec. 18, 2002) .

(n11)Footnote 11. As stated in *Weinberger*, 457 A.2d at 710 :

When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain... . The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

(n12)Footnote 12. As stated in *Weinberger*:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of the company's stock... . All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Weinberger, 457 A.2d at 711 .

(n13)Footnote 13. *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) (quoting *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1988)) .

(n14)Footnote 14. *Nixon*, 626 A.2d 1366 , is one of those cases.

(n15)Footnote 15. *Nixon*, 626 A.2d at 1381 .

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.03

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§ 11.03 Transactions in Which to Use the Special Negotiating Committee

[1] Controlling Stockholder Squeezeout

Where a controlling stockholder¹ seeks to acquire the shares of the minority stockholders in a merger transaction (assuming the majority stockholder owns less than 90 percent of the corporation's outstanding voting stock), the majority stockholder will have the burden of proving fairness in the context of a stockholder challenge to the transaction.²

Prior to 1994, the effect of the approval of a properly functioning SNC was unclear because there were two lines of cases in the Delaware Court of Chancery concerning the effect of approval of an SNC. Under the first, the approval of the SNC had the effect of changing the substantive standard of review from fairness to the business judgment rule.³ Courts applying this approach reasoned that if the SNC process really did replicate arm's-length negotiating, there was no reason not to apply the business judgment rule standard. In contrast, other decisions, such as *Citron v. E.I. duPont de Nemours & Co.*, emphasized the dominating role of the majority stockholder and held that even in the face of arm's-length negotiations, the dominant role of the majority stockholder was such to negate the change in standard.⁴

Ultimately the Supreme Court determined that the fairness standard should apply in *Kahn*. As the rationale for this holding, the Supreme Court in *Kahn*, quoted with approval the following passage from the *Citron* ⁵ case:

Parent subsidiary mergers, unlike stock options, are proposed by a party that controls, and will continue to control, the corporation, whether or not the minority stockholders vote to approve or reject the transaction. The controlling stockholder relationship has the potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.

Even where no coercion is intended, shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder. For example, the controlling stockholder might decide to stop dividend payments or to effect a subsequent cash out merger at a less favorable price, for which the remedy would be time consuming and costly litigation. At the very least, the potential for that perception, and its possible impact upon a shareholder vote, could never be fully eliminated. Consequently, in a merger between the

corporation and its controlling stockholder--even one negotiated by disinterested, independent directors--no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation.⁶ The debate on this issue may not be over however. In a recent decision, Vice Chancellor Strine suggested in *dicta* that Delaware law should be reformed to provide for business judgment rule review if a squeeze-out transaction initiated by a majority stockholder is approved by an independent special committee and subject to the approval of a majority of the minority stockholders.⁷

[2] Other Transactions Involving Controlling Stockholder

If a controlling stockholder wishes to transact business with the corporation by, for instance, selling assets to the corporation, the fairness standard will apply.⁸ A properly functioning SNC will shift the burden to the plaintiff to prove the transaction is unfair.⁹

[3] Transactions Involving Directors

A transaction between the corporation and a director or a transaction in which some members of the board may have interests different than the stockholders generally could, under certain circumstances, be reviewed under the fairness standard. For instance, in *Chaffin v. GNI Group, Inc.*,¹⁰ the board approved a merger agreement with a third party by a vote of 5-1. Two of the five board members were interested in the transaction because of the benefits they would receive under their employment agreements as a result of the merger. Of the three independent directors, two voted in favor of the transaction and one voted against. The court found that the business judgment rule did not apply because the one independent director who voted against the transaction prevented approval of the transaction by a disinterested majority. However, if an SNC negotiates and approves the transaction, the business judgment rule standard of review should apply.¹¹

[4] Transactions in Which Management Has an Interest

Sometimes it will be necessary or appropriate to have an SNC function not because of conflicts of interest at the shareholder or director level, but because of the interest of officers and management of the company in a particular transaction. The quintessential example of this type of transaction is the management buyout ("MBO") proposal in which some group from within the management of the corporation makes a proposal to buy the company.¹² In some cases, management will own some but not a significant amount of the company's stock. Classically, if only a few members of management are board members, and independent directors constitute a majority of the board, it might not be necessary to form an SNC.¹³ However, in most instances, an SNC is advisable, particularly in the context of an MBO. First, an SNC will be better able to function in the face of the MBO proposal than the full board. In the MBO context, as a practical matter, there will be heightened responsibilities placed on the committee because management, from whom board members will typically receive information and recommendations, will now be less available to the board as a source of information that can be accepted uncritically. Accordingly, the board or the committee will have to function more intensely in a "quasi management" role than it would in other contexts.¹⁴

The second reason MBO proposals typically require an SNC is that an MBO proposal will often require the board to test the market to see what other transactions are available. Thus, it is not unusual for these situations to result in a wholesale auction of the company, which could well further isolate management and diminish its role, and, in turn, require even greater participation of the committee. As a practical matter, it will be easier for a smaller group of directors to function in this context than a large group. Thus, SNCs comprised of less than all of the independent directors are sometimes formed even if a clear majority of the board is independent.

Management interests may arise in other contexts that might call for an SNC. For instance, if the company is reviewing all of its strategic alternatives, including a sale of the company, senior management may well have employment contracts that would be triggered upon a change in control. In this situation, management will have interests that are

different from the stockholders. Thus, the independent members of the board need to be able to assess the wisdom of the various strategic alternatives in such a way to be able to filter out the interests or biases of management.ⁿ¹⁵

Stockholder, director or management interests may arise in any variety of situations and transactions and corporate planners should do their best to anticipate likely scenarios which might result in the need for a special negotiating committee to function. There can be difficult judgments that must be made in this context. For instance, assume that the company has put itself up for sale and wants to conduct an active auction so as to maximize shareholder value. At the beginning of the process, senior management is asked whether it intends to participate in the auction as a buyer and its members state that they do not intend to participate in the auction. In this circumstance, it is a reasonable conclusion that an SNC is not required. However, corporate planners should carefully assess the nature of the assets of the company and the possibility that, in light of the sales process, management may change its mind.

Even in those cases where a judgment is made that an SNC is not necessary, care should be taken to preserve the flexibility to have a committee formed later in the transaction with as little disruption and delay as possible. For instance, even if a decision is made that an SNC is not necessary, it may be advisable to have the independent directors of the company, or some subgroup of them, involved in the process of interviewing and retaining advisors. In this way, if management later becomes a bidder and it is determined to be necessary to form an SNC, then the significant involvement of the independent directors early on in the advisor-retention process may permit the advisors to move into the role of advisors to the SNC.ⁿ¹⁶

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesFiduciary ResponsibilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretionBusiness & Corporate LawCorporationsShareholdersShareholder Duties & LiabilitiesControlling ShareholdersGeneral OverviewMergers & Acquisitions LawMergersDuties & Liabilities of Shareholders

FOOTNOTES:

(n1)Footnote 1. Generally under Delaware law, a person is a controlling stockholder only if it owns a majority interest in the corporation or exercises control over the business affairs of the corporation. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987). In *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110 (Del. 1994), the Supreme Court sustained the lower court's factual finding that the 43 percent stockholder of the defendant corporation had, through its conduct, exercised actual control over the corporation by "dominating its corporate officers." *Kahn*, 638 A.2d at 1114. This is one of the few instances of a Delaware court finding that a less than majority stockholder exercised actual control over the corporation.

(n2)Footnote 2. *Kahn*, 638 A.2d at 1117.

(n3)Footnote 3. *In re Trans World Airlines, Inc. S'holders Litig.*, Consol. CA 9844, 1988 Del. Ch. LEXIS 139 (Oct. 21, 1988).

(n4)Footnote 4. *Citron v. E.I. duPont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990).

(n5)Footnote 5. *Citron*, 584 A.2d at 502.

(n6)Footnote 6. *Kahn*, 638 A.2d at 1116 (quoting *Citron* 584 A.2d at 502).

(n7)Footnote 7. *In re Cox Communs., Inc. S'holders Litig.*, 879 A.2d 604, 606 (Del. Ch. 2005).

(n8)Footnote 8. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).

(n9)Footnote 9. *Kahn v. Tremont Corp.*, 694 A.2d at 428-29 ; see also *In re Emerging Communications, Inc. Shareholders Litig.*, C.A. 16415, 2004 Del. Ch. LEXIS 70, at *123-24 (Del. Ch. May 3, 2004) . In *Emerging Communications*, a member of the special committee formed to assess a going private transaction initiated by the corporation's controlling stockholder/CEO was found not to be independent because the fees he earned from consulting agreements with the CEO formed a significant percentage of his income. In addition, the committee member's son-in-law had consulting arrangements with the CEO that "would be put at risk if [the committee member] took a position overly adversarial to [the CEO]." *Id.*

(n10)Footnote 10. Chaffin, (Sept. 3, 1999) .

(n11)Footnote 11. See, e.g., *In re Western Nat'l Corp. S'holders Litig.*, Consol. CA 15927, 2000 Del. Ch. LEXIS 82 (May 22, 2000) ; *In re Nabisco, Inc. S'holders Litig.*, Consol. CA 10389, 1989 Del. Ch. LEXIS 9 (Jan. 31, 1989) .

(n12)Footnote 12. *In re Nabisco, Inc. S'holders Litig.*, Consol. CA 10389, 1989 Del. Ch. LEXIS 9 (Jan. 31, 1989) .

(n13)Footnote 13. *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) .

(n14)Footnote 14. Advisors representing an SNC in the context of an MBO should expect that more will be required of them than in a typical assignment because they will need to carry out staff and information-gathering functions that would normally be handled by management.

(n15)Footnote 15. Some might say that directors have the same conflict (i.e., a desire to stay in office) and that, for that reason, no director is independent. In general, the courts have stated that an allegation that a director took a particular action to preserve his or her director's fees or office is not sufficient to support a claim that the director is not disinterested. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) . However, this decision is premised on "typical" director fees being at issue. More recently, courts have been more receptive to allegations that a director's compensation was sufficiently large to result in the director not being disinterested. See § 11.04[1] below.

(n16)Footnote 16. This was the fact pattern in *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531 (Del. Ch. 2003) .

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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.04

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§ 11.04 Special Committee Membership

The cornerstone concepts in most of the cases dealing with both SLC and SNCs are "disinterestedness" and "independence." Except with respect to a very narrow statutory provision in the Delaware General Corporation Law,ⁿ¹ these concepts have been developed almost wholly in the case law using a common law approach. This contrasts with definitions of independence crafted by others, such as the drafters of the Model Business Corporation Act and the American Law Institute Corporate Governance Project on the one hand, and regulatory bodies such as the New York Stock Exchange, American Stock Exchange and the National Association of Securities Dealers, on the other.

The tension between a common law approach and a statutorily-defined approach has been well articulated in the commentary to Subchapter F of Chapter 8 of the Model Business Corporation Act, which deals with directors' conflicting interest transactions.ⁿ² A statutory approach provides certainty and predictability to business people so that they can plan business transactions accordingly. However, a rigid set of rules may by definition yield anomalous results in the case of conduct or decisions that seem as though they ought to be proscribed but yet fall on the "wrong" (or right depending on your perspective) side of a definition. Although which is the better approach will continue to be debated, Delaware has for the most part, adopted a common law approach. The balance of this section discusses some of the key concepts in determining independence.ⁿ³

The two paramount concepts used throughout discussions of SNCs and their functioning are "disinterestedness" and "independence." Committee members are supposed to be "independent" and free of any disabling conflict of interest ("disinterested"). The committee needs to retain "independent" advisors. A great deal is packed into these concepts and it is helpful to dissect their components carefully because interest and independence are often confused.ⁿ⁴

[1] "Disinterestedness"

A director is "disinterested" if he or she neither appears on both sides of the transaction in question nor will gain any "personal financial benefit 'from the transaction' in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."ⁿ⁵ The classic example of someone who is not disinterested is the director who is conducting business with the corporation by, for example, selling assets to or buying assets from the corporation. Note that a director may be disinterested for one purpose but not for another: a director who is buying

assets from the corporation is not disinterested in the decision whether to effect that sale or its terms. That same director may be disinterested for purposes of consideration of an unrelated transaction involving another director.

Direct involvement in a transaction is not the only factor bearing on interest. A director may also be interested if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders."⁶ An ongoing commercial relationship with the corporation may affect a director's judgment such that she may not be disinterested. For instance, assume that Director D, in addition to being a director of Corporation A, is also the owner of Supplier Corporation, all the income of which comes from a contract between Corporation A and Supplier. The board of Corporation A is considering selling Corporation A to a competitor of Supplier. If the sale is completed, Supplier's contract with Corporation A will be terminated. It is unlikely that Director D is independent for purposes of deciding whether to sell Corporation A.

Having an interest alone is not necessarily enough to disqualify a director from serving on an SNC. The interest must be "material."⁷ The relevant determination is whether interest is significant enough to the particular director in question "in the context of the director's economic circumstances, so as to have made it improbable that the director could perform her fiduciary duties ... without being influenced by her overriding personal interest."⁸ In one case involving a challenge to the purchase by one affiliate of a controlling stockholder of shares in another corporation owned by another affiliate of the controlling stockholder, a member of the SNC who was a partner in a small law firm that received large fees from the controlling stockholder was found not to be independent.⁹ Similarly, other members of the committee who had significant consulting arrangements with the controlling stockholder and its affiliates were also found not to have been independent as a result of those consulting arrangements.¹⁰

As a general rule, because of the nature of the materiality test, it will often be difficult to conclude with certainty whether particular directors who have ongoing commercial or consulting arrangements with the corporation or affiliates of parties involved in a transaction will be disinterested. As discussed elsewhere, counsel should keep in mind the purpose of having an SNC in the first place and, in consultation with his or her clients as appropriate, weigh the benefits and risks of proceeding in the face of the uncertainty. One reasonably clear exception is in the case of high net worth individuals who serve on committees and for whom consulting or employment arrangements, while perhaps significant in an objective way, may be found to be insignificant to the particular individual.¹¹

It is also important for counsel to understand where the consulting arrangements originated and how they were approved. For instance, did they come about solely with the approval of management or was the board involved in approving the particular relationship. In the former case, it is more likely that the director will be seen by a court as being "in the pocket" of management.

There are several well-recognized situations that cause directors not to be disinterested. First, if D is a director of both Corporation A and Corporation B, and Corporation A and Corporation B are engaging in a significant commercial transaction, D cannot be deemed disinterested because she will have fiduciary duties to act in the best interest of each of the corporations.¹²

Second, the transaction may be between the corporation and the director herself, or an entity in which she has a significant (material) economic interest.

Third, other financial or business relationships may compromise disinterestedness. A director who is also an officer or employee of the corporation may have significant interests in his status as an officer or employee, as opposed to his status as a shareholder.¹³ Similarly, directors sometimes have consulting arrangements with the corporation. Those consulting arrangements may be significant enough to cause the director to be considered non-independent. A 2003 case raises the possibility that, depending on a director's income and net worth, a director's expectation of compensation as a director may need to be analyzed to determine disinterestedness.¹⁴ The key in examining each of these relationships is whether the director will have a sufficient economic interest in continuing or maintaining the relationship with the

corporation, or in the terms of the consulting contract or his office as a director, such that the director is not in a position to make a business judgment based on what is in the best interest of the stockholders.

In a recent case, the Delaware Court of Chancery assessed whether a *potential* conflict of interest of two special committee members was enough to find them interested in a decision to terminate the employment of the corporation's founder, who was also the Chairman, CEO and President of the company.¹⁵ After the special committee decided to terminate the founder, one Committee member took over the position of "non-executive Chairman" and the other became the president and CEO. The Court found that the committee members were not motivated by the potential to fill the offices vacated by the individual whose employment they voted to terminate. In so finding the Court wrote about potential conflicts:

Directors are not conflicted simply because they have the potential to be conflicted; they are conflicted because their loyalties are divided in such a way that they are unable to serve in the best interests of the corporation. Thus, to declare a director to have a disabling, disqualifying conflict of interest requires a finding that the nature of the director interest is "substantial" or "material," but not "merely incidental" or, in this case, "potential."¹⁶

The Court reached this conclusion even though the resolutions forming the special committee included a recital that the committee was to be comprised "exclusively of non-management directors who have no potential conflict of interest."¹⁷

[2] Independence

The directors serving on the SNC must also be "independent." Independence means that the "director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."¹⁸ This concept can be somewhat more amorphous than "interest" and involves determining whether the director is " beholden " to an interested party in the particular transaction or otherwise incapable of independent judgment.

Familial relationships are one reasonably clear factor that will compromise independence. Thus in one case, a director was found to have lacked independence with respect to a transaction that financially benefited his son.¹⁹ In another case, a director who was the brother-in-law of the chief executive officer of a corporation and involved in various businesses with the CEO was found not to have been able to consider impartially a stockholder demand that was adverse to the CEO's interest.²⁰ Note that the courts have not typically inquired into the nature of or details concerning the familial relationship. Thus, courts have not considered whether the *actual* relationship between a mother and daughter is so estranged that one could be considered independent from one another.

The strong, domineering personality of a chairperson of the board of directors could result in directors, even though outwardly independent, being found not independent. Thus, in one case, the Chancery Court found that two of the three directors of a company were dominated by the third director who was the company's president and controlling stockholder.²¹ The court stated:

It is perfectly evident to me that Odlum dominated and controlled those members of Airfleet's board who [made the decision in question]. I use "dominated" and "controlled" in the sense that, criminality aside, his wishes were their commands. My conclusion is drawn from the interplay of several circumstances; some tangible and others intangible: the two directors who voted to reject the offer were both, realistically speaking, beholden to Odlum; Odlum was and is Airfleet's president and a member of its board; the manner in which the corporate affairs were handled as among the board members showed that realistically this was a one-man board - an Odlum board... I emphasize that my conclusion is based not merely on the manner in which the various director relationships were created but on the cumulative effect of the trial record.²²

In contrast to this finding, which was made after trial, the election of a director by a controlling stockholder, standing alone, does not compromise the independence of the directors.ⁿ²³

Actions by a controlling person may result in a director being found to be not independent, as was the case in *Kahn*. Other, less obvious relationships, may bear on independence and can require some skillful vetting by counsel. For instance, in one case,ⁿ²⁴ the acquisition of a private corporation by a public corporation was challenged. The corporations had a common stockholder that owned approximately 40 percent of the common stock of each. The common stockholder had the same representative (Mr. Wadsworth) on the board of each corporation. The Court of Chancery, ruling on the defendants' motion to dismiss the complaint, questioned the independence of one member (Mr. Blaesar) of a special committee appointed by the board of directors of the public company to negotiate the transaction because Mr. Wadsworth was also the chair of the compensation committee of a third corporation of which Mr. Blaesar was president and chief executive officer. The court found that Mr. Wadsworth was "uniquely situated to influence the level and timing" of Mr. Blaesar's compensation. Although acknowledging that Mr. Wadsworth, as the chair of the compensation committee, undoubtedly had "limited power to act unilaterally,"ⁿ²⁵ the court found reason (at least at the motion to dismiss stage) to doubt Mr. Blaesar's ability to disregard Mr. Wadsworth's interests as the representative of a significant investor in the acquiring and acquired companies.

It is an unhappy fact of life that, in some circumstances, generally dependent upon when counsel is hired in the SNC formation process, counsel to the SNC may have to "fire" one of his clients in the sense that she may have to recommend to the SNC or to the full board that a director previously placed on the SNC no longer serve on the SNC.

When faced with these situations and in assessing generally questions of committee membership and independence, counsel, the SNC and the board should keep in mind the purpose of the SNC process--ensuring that if the SNC decides to approve or recommend a transaction, that transaction will be completed. A transaction has a greater likelihood of being sustained in the face of a challenge if it has been approved by a committee comprised of clearly independent directors. In light of this, in cases in which the independence of any particular director is not clear, counsel and the SNC should carefully weigh including that director on the committee.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities Duty of Loyalty Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion

FOOTNOTES:

(n1)Footnote 1. *Del. Code Ann. tit. 8, § 144*.

(n2)Footnote 2. Model Bus. Corp. Act--Official Text, Section 8.60 pp. 8-134-8-136 (2005).

(n3)Footnote 3. Note that the cases discussing disinterestedness and independence in the special litigation committee context have generally had equal application to special negotiating committees and vice versa. A recent case in the special litigation committee area, *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (*Del. Ch.* 2003), discussed below, suggests that equal application should not necessarily be the case. Specifically, the court stated that a director might find it:

[E]asier to say no to a friend, relative, colleague, or boss who seeks assent for an act (*e.g.*, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person... . Denying a fellow director the ability to proceed on a matter important to him may not be easy, but it

must, as a general matter, be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him.

Oracle Corp., 824 A.2d at 940 . Similarly, in *Beam v. Stewart*, 845 A.2d 1040, 1055 n.45 (Del. 2004) , the court noted that the analysis applied to determine the independence of a special negotiating committee has procedural characteristics different from those applied to a special litigation committee or to presuit demand cases. Exactly where the line of demarcation is (or will be) between the concepts of disinterestedness and independence for special litigation committees and special negotiating committees cannot be identified with certainty at this point, although it appears that the standards will be more exacting for SLCs than SNCs. Counsel faced with the question should carefully review developments in the area.

(n4)Footnote 4. *See Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002) .

(n5)Footnote 5. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) .

(n6)Footnote 6. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993) .

(n7)Footnote 7. *Cede & Co. v. Technicolor, Inc.*, 663 A.2d 1134, 1151-1152 (Del. Ch. 1994) , *aff'd*, 663 A.2d 1156 (Del. 1995) .

(n8)Footnote 8. *In re GM Class H Shareholders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999) .

(n9)Footnote 9. *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) .

(n10)Footnote 10. *Kahn v. Tremont Corp.*, 694 A.2d at 429 . *see also In re Emerging Communications, Inc. Shareholders Litig.*, C.A. 16415, 2004 Del. Ch. LEXIS 70, at *123-24 (Del. Ch. May 3, 2004) . In *Emerging Communications*, a member of the special committee formed to assess a going private transaction initiated by the corporation's controlling stockholder/CEO was found not to be independent because the fees he earned from consulting agreements with the CEO formed a significant percentage of his income. In addition, the committee member's son-in-law had consulting arrangements with the CEO that "would be put at risk if [the committee member] took a position overly adversarial to [the CEO]." *Id.*

(n11)Footnote 11. *In re The Student Loan Corp. Derivative Litig.*, CA 17799, 2002 Del. Ch. LEXIS 7 (Jan 8, 2002) suggests that the case in which the compensation of a person does not create an interest will be the exception, not the rule:

Absent some unusual fact--such as the possession of inherited wealth--the remuneration a person receives from her full-time job is typically of great consequence to her. It is usually the method by which bills get paid, health insurance is affordably procured, children's educations are funded, and retirement savings are accumulated.

Student Loan, 2002 Del. Ch. LEXIS 7, at *9, n.3 .

(n12)Footnote 12. *See, e.g., In re Freeport-McMoRan Sulphur, Inc. Shareholder Litig.*, C.A. 16729, 2005 Del. Ch. LEXIS 96, at *29 (Del. Ch. June 30, 2005) ("[E]ven if their economic interests were immaterial, the Common Directors were still not able to act independently in the transaction because they sat on both boards and owed the same duty of loyalty to both companies.").

(n13)Footnote 13. *See, e.g., In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007) (explaining how a CEO's desire to secure the payment of accrued retirement benefits, his interest in continued employment, and achieving

liquidity for his shares made his economic motivations in supporting a going-private merger sufficiently different from those of public stockholders and made his appointment by a special committee of admittedly independent, disinterested directors as a negotiator to represent the interests of the public stockholders "less-than-ideal"); *But see Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 175-76 (Del. Ch. 2005) (finding that a CEO was not interested in a transaction that effectively diluted the percentage of shares held by the plaintiff, the controlling stockholder, and, according to the plaintiff, "removed a threat" to the CEO's incumbency).

(n14)Footnote 14. *See In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531, 536 (Del. Ch. 2003) (noting that the compensation of a particular director was not "a material portion of his annual income or of his net worth"). The Court in *Emerging Communications* found that a member of a special committee was not independent due in part to "generous" director and committee fees that represented 10% of the committee member's annual income. The committee member's expectation of continued service as a director in the majority shareholder/CEO's companies after the closing of the going private transaction that the special committee was assessing was also a factor. The Court wrote: "That expectation, coupled with the fact that his director and committee fees represented a sizeable portion of his income, was sufficient to vitiate [the committee member's] independence for purposes of considering objectively whether the Privatization was fair to minority stockholders." *In re Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *126-127 .

(n15)Footnote 15. *Perlegos v. Atmel Corp.*, C.A. 2320-N, 2007 Del. Ch. LEXIS 25 (Del. Ch. Feb. 8, 2007) .

(n16)Footnote 16. *Id.* at *65.

(n17)Footnote 17. *Id.* at *64.

(n18)Footnote 18. *Aronson*, 473 A.2d at 816 .

(n19)Footnote 19. *Chaffin v. GNI Group, Inc.*, CA 16211, 1999 Del. Ch. LEXIS 182 (Sept. 3, 1999) .

(n20)Footnote 20. *Harbor Finance Partners v. Huizenga*, 751 A.2d 879, 886-89 (Del. Ch. 1999) . *See also In re Emerging Communications, Inc. S'holders Litig.*, CA 16415, 2004 Del.Ch. LEXIS 70 (June 4, 2004) (affirmative finding that member of SNC was beholden to the controlling stockholder strengthened because the committee member's son-in-law had a consulting agreement with the controlling stockholder).

(n21)Footnote 21. *Greene v. Allen*, 35 Del. Ch. 242, 114 A.2d 916 (Del. Ch. 1955) , *rev'd on other grounds sub nom.*, 35 Del. Ch. 479, 121 A.2d 919 (Del. 1956) .

(n22)Footnote 22. *Greene*, 114 A.2d at 920 . As discussed *below*, the Chancery Court in *Kahn* made similar findings of fact to conclude that the 43 percent stockholder was, as a matter of fact, a controlling stockholder.

(n23)Footnote 23. *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53 (Del. 1989) .

(n24)Footnote 24. *Skeen v. Wadsworth*, CA 20110, 2003 Del. Ch. LEXIS 63 (June 18, 2003) .

(n25)Footnote 25. *Skeen*, 2003 Del. Ch. LEXIS 63 . Query whether it would have made a difference if the representative director had been simply a member of the compensation committee instead of its chair.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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Corporate Governance: Law and Practice

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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.05

AUTHOR: S. Mark Hurd Andrew M. Johnston

§ 11.05 Simulating Arm's Length Negotiations

As discussed earlier, the essence of the SNC process is to simulate arm's-length negotiating so that investors and a reviewing court can have confidence in the result. There are two paramount elements in determining whether the SNC's work should be respected: the committee's authority to negotiate, and its ability to be informed.

[1] Committee Authority

The SNC's authority is largely a function of the terms of action, typically a board resolution. The second aspect is the reality of negotiation, which in turn depends on the SNC's understanding of its job and the other party not acting in such a way as to deprive the SNC of its ability to negotiate.

As to the committee's understanding of its role, courts have found the approval of a transaction by an SNC wanting when it was apparent that the SNC did not understand that its job was not simply to "bless" a transaction, but to assess it critically and rigorously, and then act on the transaction in light of the SNC's authority. This does not mean simply achieving a "fair transaction" or a transaction as to which an investment banker can deliver a fairness opinion. Rather, the SNC's responsibility is to approve a transaction only if it believes that it is the best transaction available to the company.ⁿ¹

An example of a misguided committee is found in *In re Trans World Airlines, Inc. Shareholders Litigation*.ⁿ² In that case, involving an offer by a majority stockholder to buy the interests of the minority stockholders, the court found that the members of the special committee "did not seem to understand that their duty was to strive to negotiate the highest or best available transaction for the shareholders whom they undertook to represent."ⁿ³ As support for this conclusion, the court quoted a testimony from the two members of the special committee that suggested that they believed that the committee's obligation was to achieve a transaction as to which their investment banker could render a fairness opinion.ⁿ⁴ Ultimately, the court stated that:

The special committee did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary. *Weinberger v. UOP Inc.* envisions that minority interests can be protected by a special committee that emulates that arm's-length process. But the burden shifting effect will not occur where the special committee did not

adequately understand its function--to aggressively seek to promote and protect minority interests--or was not adequately informed about the fair value of the firm and the minority shares in it.ⁿ⁵

Although the court did not reach a final conclusion as to the efficacy of the committee because of the preliminary nature of the relief sought, it found that "substantial questions" had been raised about the effectiveness of the committee.

An SNC may be faced with situations in which it is unable to negotiate actual improvements in a transaction by the time the transaction is presented to it. For instance, assume that active and independent management "pre-negotiates" a transaction with a majority stockholder so that, by the time the transaction is presented to the SNC, there is nothing left to negotiate (at least from the perspective of the party proposing the transaction). Is an SNC required to reject a transaction in this circumstance? Delaware courts have recognized that the essence of negotiation is the ability of an SNC to say no to a transaction.ⁿ⁶ If the SNC fully understands that it has this ability, understands the basis for improvements to the transaction that have already been previously negotiated, and ultimately satisfies itself, perhaps through an attempt to negotiate improvements itself, that a better transaction is not available, the "pre-negotiation" should not necessarily mean that the SNC cannot appropriately approve the transaction. This scenario puts the SNC in an awkward position, however, and should be avoided.ⁿ⁷

An example why this scenario should be avoided is found in *In re SS&C Technologies, Inc. Shareholders Litig.*ⁿ⁸ In this case, the Delaware Court of Chancery disapproved a settlement agreement between plaintiff stockholders challenging a management-led cash-out merger and the defendants. The corporation's Chairman and CEO had initiated talks with a private equity group that eventually led to the corporation being taken private and the CEO gaining a large equity interest in the surviving entity as well as a new employment agreement. The board of directors established a special committee of disinterested directors that was given the power to explore alternatives to the deal that the CEO brought to the corporation. The committee also had the power to consider, accept, or reject any acquisition proposal and to retain independent legal and financial advisors. The committee ended up accepting the CEO's deal but managed to win some advantages for the stockholders-including a slight bump in the offering price. However, in rejecting the settlement, the Court discussed its discomfort with the process by which the deal was approved:

[D]id [the CEO's] general agreement to do a deal with [the private equity firm] make it more difficult for the special committee to attract competing bids, especially from buyers not interested in having [the CEO] own a significant equity interest in the surviving enterprise? And, did [the CEO's] negotiation of a price range with Carlyle unfairly impede the special committee in securing the best terms reasonably available?ⁿ⁹

Although this case did not deal directly with the efficacy of the special committee, the Court did raise some important questions regarding the pre-negotiation of some of the terms of a transaction. The Court had these reservations despite the committee's broad powers and independence and despite its ability to win some concessions for stockholders.

The SNC and its advisors should also be clear about the interests the SNC is seeking to protect in the transaction. In *Levco Alternative Fund Ltd. v. The Readers Digest Association, Inc.*,ⁿ¹⁰ plaintiff challenged a recapitalization transaction for a company with two classes of common stock: Class A common stock, which was nonvoting and was held by the public; and Class B common stock, which was entitled to vote and was held by members of the family that founded the corporation and trusts that were affiliated with those family members. In the transaction, the company had agreed to purchase shares of its Class B common stock for cash from certain holders. The remaining Class B common shares would be reclassified at a premium for shares of a new class of common stock, and each outstanding share of nonvoting Class A common stock would be reclassified into one share of the new common stock. An SNC was appointed to evaluate the fairness of the transaction. The Chancery Court had found that the SNC regarded its role as protecting the interests of the corporation as a whole rather than the interests of the holders of any particular stock.

On appeal, the Supreme Court of Delaware ruled that, given the differing interests of the two classes of common stock

in the transaction, the special committee's functioning was flawed because it evaluated the transaction (and the purchase of the Class B common stock for cash in particular) from the perspective of the corporation as a whole rather than from the perspective of the holders of the Class A common stock. In this regard, the Supreme Court of Delaware found it important that the special committee did not obtain from its financial advisor an opinion that the transaction was fair to the holders of the Class A common stock.ⁿ¹¹

Second, the process must be conducted in such a way that the court will have confidence that the SNC was actually able to negotiate. Thus, if one party acts in such a way so as to effectively deprive the SNC of its ability to negotiate or if the SNC conducts negotiations in a problematic way, an SNC's ultimate approval of the transaction may not have any legal effect. For example, in *Kahn*, the court found that the SNC had been effectively deprived of its ability to negotiate a transaction as a result of threats by the majority stockholder to circumvent the SNC by making a business acquisition proposal directly to the stockholders at a lower price than it had been discussing with the SNC.ⁿ¹²

Precisely where the line is between "hard bargaining" by an interested party and actions that deprive an independent committee of its ability to negotiate a transaction is not necessarily clear. For instance, in one case, the Delaware Chancery Court found no fault with the 80 percent stockholder who initially began negotiations with an SNC but later broke off those negotiations and made a tender offer directly to the corporation's stockholders and subsequently effected a short-form merger.ⁿ¹³ Nonetheless, interested parties in transactions, particularly majority stockholders in light of the *Kahn* case, must be careful to avoid tactics that might be seen as "heavy handed" or threatening if they wish to have the benefits of SNC approval.

Courts will also take into account how the SNC chose to negotiate the transaction. Of particular importance is who the SNC selects to conduct the negotiations and the involvement of the SNC in the negotiations themselves (or in overseeing the negotiations). Typically, the SNC's investment banker will negotiate the financial parameters of the transactions. Counsel to the SNC will tend to the legal issues, and one or more members of the SNC would be involved in direct, face-to-face negotiations on significant, "deal breaker" points. Other approaches are, of course, possible but the SNC and its advisors should be sensitive to options that could cause concern about the effectiveness of the negotiating strategy. For instance, in one case,ⁿ¹⁴ an SNC was formed to negotiate the terms of an acquisition with the corporation's chief executive officer, who was also a director and a significant stockholder. The complaint alleged that the SNC delegated to another director, who was not a member of the SNC, the authority to negotiate the terms of the transaction. This director was also an officer of the corporation and, so the complaint alleged, beholden to the CEO. On the basis of this allegation and other alleged flaws in the process, the Court of Chancery denied defendants' motion to dismiss the plaintiff's claims.

In a recent case, *In re Lear Corporation*, the special committee gave the CEO the power to negotiate, without the participation or supervision of the special committee, a going-private merger that allowed him to liquidate his equity holdings, accelerate and secure his retirement benefits, and continue in a managerial position in the private company.ⁿ¹⁵ The Court found that this method of conducting negotiations was "far from ideal and unnecessarily raises concerns about the integrity and skill of those trying to represent [the target's] public investors."ⁿ¹⁶ The special committee's decision to delegate to the CEO the power to negotiate the merger was a factor in the Court's decision to grant an injunction preventing a vote on the merger. The merger proxy materials did not disclose that, prior to entering into merger discussions with the buyer, the CEO negotiated with the board over concerns he had about his retirement and his equity stake in the company.ⁿ¹⁷ The Court wrote:

Because the CEO might rationally have expected a going private transaction to provide him with a unique means to achieve his personal objectives, and because the merger ... in fact secured for the CEO the joint benefits of immediate liquidity and continued employment that he sought just before entering the merger, [the target] stockholders are entitled to know that the CEO harbored material economic motivations that differed from their own that could have influenced his negotiating posture... . Given that the Special Committee delegated to the CEO the sole authority to conduct the merger negotiations, this

concern is magnified.ⁿ¹⁸

The Court issued an injunction until the proxy statement could be amended to inform the stockholders of the CEO's prior talks with the board.ⁿ¹⁹

As a result of the nature of most SNC projects, it is to be expected that decisions made by the SNC will be looked at, second-guessed and perhaps criticized. This highlights the need for the SNC to ask hard questions, test assumptions, be thoroughly informed and explore alternatives. Although no process is ever perfect, SNC assignments demand prudent, informed action. If, as a result of deadlines or other time pressures, the SNC is not able to explore an area or procure information that, without the time constraint, it would otherwise obtain, the SNC should specifically consider the constraint and make a decision not to get the additional information. As one court has recognized, a decision not to obtain more information either because of its cost or otherwise, is much a business judgment that ought to be respected as any other decision that a board or committee can make.ⁿ²⁰

In this context, SNCs and their counsel should be aware that, in certain circumstances, legal avenues to obtain information that might not be available in other circumstances may be available in the SNC process. Specifically, in *Kahn v. Tremont*,ⁿ²¹ Chancellor Allen found that a majority stockholder had a duty to provide to an SNC certain information that the majority stockholder had prepared in connection with a proposal to have two affiliated companies with a common parent swap certain assets. This information included material facts relating to the use or value of the assets in question to the corporation including, for instance, alternate uses of assets or "hidden value" (e.g., there is oil under the land subject to negotiation) and all material facts that the majority stockholder knows relating to the market value of the corporation including such facts as "forthcoming changes in legal regulation or technological changes that would affect the value of the assets in question" either to the corporation or to others. On the other hand, the Chancellor recognized that there were certain categories of information that a majority stockholder did not have a duty to disclose, such as the top price the majority stockholder would pay.

The extent of financial data that a controlling stockholder must provide may not always be completely clear. In one case,ⁿ²² for example, the Delaware Court of Chancery found that the controlling stockholder's failure to provide the SNC with the company's most recent financial projections, which were markedly improved over earlier projections, resulted in an uninformed SNC. In contrast, in *In re Cysive, Inc., Shareholders Litigation*,ⁿ²³ a case involving a management buyout by the CEO (who controlled approximately 40% of the company's stock), the CFO, and other members of senior management, the Court of Chancery Court, while noting that the CFO's failure to provide a budget featuring revised revenue figures to the SNC was "unwise and improper" nonetheless held that this omission did not impair the functioning of the SNC or its advisors. The financial projections withheld in these cases are factually distinguishable, which may explain this disparity of treatment. First, unlike the financial data in *Emerging Communications*, the financial projections withheld in *Cysive* reflected a less favorable forecast of the company's value than the financial data previously provided to the *Cysive* SNC. Moreover, the *Cysive* court found that the projections that the CFO failed to provide to the SNC were not reliable revenue projections, while the *Emerging Communications* court did not discuss the reliability of the omitted information in that case. These cases therefore illustrate that withholding certain, but not all, types of financial information from an SNC may render the SNC uninformed.

[2] Committee Powers

Typically, an SNC would be established as the result of the adoption by a board of directors of a resolution establishing the committee, appointing its members and specifying the committee's authority and responsibilities. Several factors can affect the powers and responsibilities that are delegated to the SNC. First, the applicable corporation statute and the corporation's certificate of incorporation and bylaws may limit the board of directors' authority to delegate powers to an SNC. For instance, under Section 141(c)(2) of the Delaware General Corporation Law, a board of directors may delegate to a committee all of the powers and authority of the board of directors in the management of the business and affairs of the corporation except that the committee may not have the power or authority to: (1) approve or adopt, or

recommend to the stockholders, any action or matter expressly required by the Delaware General Corporation Law to be submitted to stockholders for approval; or (2) adopt, amend or repeal any bylaws of the corporation. Thus, an SNC may not be delegated the authority to approve a proposal to acquire the corporation by merger under Section 251 of the Delaware General Corporation Law, as that section generally requires stockholder approval of such a merger.ⁿ²⁴ Second, the certificate of incorporation and bylaws of a corporation may also limit or proscribe what may be delegated to a committee.

Each of these limitations should be kept in mind throughout the committee process. For instance, a committee assignment that began as the negotiation and approval of the issuance of a large block of stock to an existing stockholder, which can be delegated to a committee, may evolve into a merger transaction, which, under the Delaware General Corporation Law, cannot.

An SNC that cannot be delegated the authority to approve a transaction because of limitations imposed by the corporation law may be given the authority to negotiate the transaction on behalf of the corporation and to make a recommendation to the full board of directors whether the board approve the transaction. Even if a transaction is one which can be fully delegated to an SNC, counsel, and ultimately the full board, must nonetheless decide at the outset whether the transaction should be brought back to the full board for approval. In some cases, this will be a fairly straightforward question. For instance, if all of the non-committee members on the board have a direct conflict of interest because they are officers of a corporation that is the other party to the transaction, in most cases it will be clear that the SNC should have the full authority to approve the transaction. Suppose, however, that some board members do not (or may not) have a conflict of interest but they are nonetheless not on the committee.ⁿ²⁵ Nonconflicted board members in this position may feel a responsibility as board members to be involved in the final decision to approve the transaction. It is hard to argue with them if they decide to have the SNC negotiate a transaction that is brought back to the full board for consideration and approval.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesDefensesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesFiduciary ResponsibilitiesDuty of LoyaltyBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityDiscretionBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityLimitationsBusiness & Corporate LawCorporationsShareholdersShareholder Duties & LiabilitiesControlling ShareholdersFiduciary Responsibilities

FOOTNOTES:

(n1)Footnote 1. Although in theory a committee could approve a transaction that it was convinced was the best transaction available to it, but as to which an investment banking firm could not deliver a fairness opinion, in reality, that is an exceedingly unlikely result.

(n2)Footnote 2. *In re Trans World Airlines, Inc. S'holders Litig.*, CA 9844, 1988 Del. Ch. LEXIS 139 (Oct. 21, 1988) .

(n3)Footnote 3. *Trans World Airlines*, 1988 Del. Ch. LEXIS 139, at *12.

(n4)Footnote 4. *Trans World Airlines*, 1988 Del. Ch. LEXIS 139, at *11-12.

(n5)Footnote 5. *Trans World Airlines*, 1988 Del. Ch. LEXIS 139, at *21.

(n6)Footnote 6. *Clements v. Rogers*, 790 A.2d 1222, 1241 (Del. Ch. 2001) .

(n7)Footnote 7. In *In Re Netsmart Technologies, Inc. Shareholders Litig.*, the Court found that management's decision, which was made prior to the formation of a special committee, to pursue a private-equity going-private merger over a strategic merger, hamstrung the committee's work. 924 A.2d 171 (Del. Ch. 2007) . The Court wrote: "By the time the Special Committee began its work, the inertial energy of the sales process was already clearly directed at a private equity deal." *Id.* at 199 . The Court found there was a reasonable probability that, in part, the "board's failure to engage in any logical efforts to examine the universe of possible strategic buyers" was a breach of the board's *Revlon* duties. *Id.*

(n8)Footnote 8. 911 A.2d 816 (Del. Ch. 2006) .

(n9)Footnote 9. *Id.* at 820 .

(n10)Footnote 10. *Levco Alternative Fund Ltd. v. Reader's Digest Ass'n*, 803 A.2d 428 (Del. 2002) .

(n11)Footnote 11. See also *In re Tele-Communications, Inc. Shareholders Litig.*, C.A. 16470, 2005 Del. Ch. LEXIS 206 (Del. Ch. Dec. 21, 2005) , in which, the Court denied the defendant's motion to dismiss plaintiffs' claim that a merger was not entirely fair. The suit was brought by holders of a series of stock (Series A) who claimed that they had been treated unfairly in the merger relative to the Series B holders. The Court first found that entire fairness applied to the merger because a majority of the directors owned more Series B shares than Series A. The approval of the transaction by a special committee did not shift the burden of proof because the special committee's two members, when their holdings were combined, owned more Series B stock than the Series A stock. When combined with their compensation, which the Court described as very high (\$1 million a piece) and the amount of which was established only after the committee had completed its work and approved the transaction, the unbalanced holdings led the Court to conclude that the burden of proving entire fairness should not be shifted. Following *Levco*, the Court found that the committee failed to properly assess the merger from the perspective of the Series A holders: "In the present transaction, the Special Committee failed to examine, and [the financial advisor] failed to opine upon, the fairness of the [Series B] premium to the [Series A] holders." *Id.* at *54-55.

(n12)Footnote 12. *Kahn*, 638 A.2d at 1119-1121.

(n13)Footnote 13. *In re Siliconix Inc. S'holders Litig.*, CA 18700 (Del. Ch. June 19, 2001).

(n14)Footnote 14. *California Pub. Employees' Ret. Sys. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144 (Dec. 18, 2002) .

(n15)Footnote 15. 926 A.2d 94 .

(n16)Footnote 16. *Id.* at 116-17 . Even though the Court found the special committee's approach to negotiations "less than confidence inspiring," it held that the plaintiffs were unable to make a valid *Revlon* claim. In this case, allowing the CEO to negotiate merger terms did not adversely affect "the overall reasonableness" of the effort to secure the highest possible value for the company. *Id.* at 97-98 .

(n17)Footnote 17. *Id.* at 114 .

(n18)Footnote 18. *Id.* at 98 .

(n19)Footnote 19. *Id.*

(n20)Footnote 20. *In re Nabisco S'holder Litig.*, 1989 Del. Ch. LEXIS 9 (Feb. 14, 1989) . Compare this to *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003) in which the Chancellor refused to dismiss a claim that implied that the directors who knew they were making a decision without adequate information and deliberation and "simply did not care if the decisions caused the corporation and its stockholders" to suffer loss or

injury.

(n21)Footnote 21. *Kahn v. Tremont Corp.*, CA 12339, 1996 Del. Ch. LEXIS 40 (Mar. 21, 1996) , rev'd on other grounds, 694 A.2d 422 (Del. 1997) .

(n22)Footnote 22. *In re Emerging Communications, Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 70 (June 4, 2004) .

(n23)Footnote 23. *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531 (Del. Ch. 2003) .

(n24)Footnote 24. Subsection 2 was added to Delaware General Corporation Law § 141(c) in 1996. Prior to that time, Section 141 was more restrictive in terms of the powers that could be delegated to a committee. The pre-1996 provision, which is now found in Section 141(c)(1), is applicable to corporations incorporated prior to July 1, 1996 that do not, by board resolution, opt into the liberalized provisions of Section 141(c)(2). Corporations incorporated on or after July 1, 1996 are automatically governed by Section 141(c)(2). *See Del. Code Ann. tit. 8, § 141(c)(1), (2)* (2007).

(n25)Footnote 25. This situation could occur for a variety of reasons including a director having other commitments that prevent him or her from devoting adequate time to the assignment. If nonconflicted board members choose not to serve on an SNC, the minutes should reflect the reason for the decision not to have those members on the committee to avoid questions regarding composition of the committee.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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Corporate Governance: Law and Practice

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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

*2-11 Corporate Governance: Law and Practice § 11.06***AUTHOR:** S. Mark Hurd Andrew M. Johnston**§ 11.06 Common Committee Characteristics and Issues****[1] Committee Composition**

Once counsel has identified who the disinterested and independent members of the board of directors are, he or she will have to consider who among the board members ought to be on the SNC. Many factors enter into this decision, such as the subject matter of the special committee assignment and the availability of the potential SNC members. For instance, directors who have a technical background may be better suited to negotiate the terms of a licensing agreement for complicated intellectual property than other directors. Similarly board members who have substantial merger and acquisition experience may be better suited to assist in the negotiation of a change of control transaction. Knowing who on the SNC might have this background can be particularly important in SNC assignments because the SNC may not have the kind of access to some of the usual sources of background information and expertise that it would normally have. For instance, in a management buyout transaction, the SNC likely will not have the access to management that it would in a third-party transaction. A properly prepared authorizing resolution should permit the SNC to hire experts to work with it. However, there is no substitute for first-hand experience in the subject matter of the committee's assignment.

Although the composition of the committee may vary depending on the nature of the assignment, there is one universal: SNC members should understand that serving on an SNC will often involve a significant commitment of time, attention and energy. If a prospective committee member is either unable or unwilling to make himself or herself available to meet those commitments, he or she should not serve on the committee. The benefits to be derived from establishing an SNC are not well served by having committee members who are unable or unwilling to function effectively.

[2] Number of Committee Members

The number of members that should serve on the SNC will depend on several factors, including practicality and effectiveness.¹ An SNC that has too many members may not be able to function effectively because it will be difficult to bring committee members together as needed. An SNC with too few members may not have the collegial exchange of views and perspectives that make the committee process effective. This is particularly true when one or more committee members is regularly absent from committee meetings. For an SNC of two members, counsel should be sure that the members understand the importance of participation at all SNC meetings because if one SNC member is

unavailable, the SNC is incapable of action. Generally an SNC of three to four members is preferable.

SNCs made up of a single member are to be avoided if at all possible. The courts will be suspicious of an SNC with only one member, perhaps in part because having a one-person committee places a significant burden on that director and his or her advisors as she will not have the benefit of interaction with other committee members that is such an important part of an SNC's decision-making process.ⁿ² On occasion, a one-member committee is unavoidable. In such a situation, all steps possible should be taken to make sure that the SNC member has advisors with whom he or she is comfortable and trusts and that the SNC has whatever additional supporting cast, such as consultants and experts, that she feels may be necessary.

[3] Compensation of Committee Members

As discussed above, members of an SNC should expect that significant demands will be made on them when serving on an SNC. It is only appropriate in those circumstances that the SNC members be adequately compensated for these demands. Standard fee arrangements include: a fixed, flat amount; a per meeting fee; or a combination thereof. Depending on the nature of the assignment, a fee of as much as \$50,000 or more is not out of the question. Although flexibility in structuring the fees for the SNC is possible, a compensation arrangement that is contingent on a particular outcome, such as a fee expressed as a percentage of the transaction that is contingent on the closing of a transaction, should be avoided.ⁿ³ This type of fee arrangement could be seen as giving the SNC members an incentive to reach a particular result, *i.e.*, the one that results in the fee being paid, in a circumstance in which that result might not be in the best interests of the stockholders. As a result, this type of fee arrangement could cause the committee members to be seen as no longer disinterested and independent, when it is their disinterestedness and independence that has resulted in their membership on the SNC in the first place. Although there may be a highly unusual circumstance in which this type of arrangement could be considered,ⁿ⁴ it generally should not be recommended.

The fee arrangement should account for the SNC work that might be conducted outside of meetings. Important work of the SNC, such as discussing committee business with other SNC members or advisors, reviewing materials, interviewing personnel, participating in negotiations or having a deposition taken, will take place outside of the meeting context.

It is a good idea to reflect in the minutes of the board meeting at which the SNC is created the board's expectation for the duration of the SNC's activities. In this way, if the work of the SNC ends up taking significantly longer than had been originally expected, there is a basis for the SNC members and the board to revisit the SNC's compensation.

Counsel should have a candid discussion with the SNC members about their expectations concerning fees and fee arrangements should be made at the *beginning* of the committee process. If discussions about fees are put off until the end of the committee process, it could appear that the SNC was somehow "bought off."ⁿ⁵ A fee discussion will also be a good opportunity for counsel to impress upon the SNC members the time commitment necessary for the effective operation of the SNC. Changing the compensation arrangement in the middle of the SNC process can bring about problematic consequences.ⁿ⁶

[4] Indemnification and Director Liability Protections

At an early stage in the SNC assignment, counsel should review the relevant documents to ascertain what indemnification rights, rights to the advancement of expenses, protections from liability provisions and rights under insurance policies are available to committee members, so as to identify any "holes" in or deficiencies from the protections typically afforded directors.ⁿ⁷ Counsel should consult with the SNC members concerning the available protections and the means, if any, available to fill any holes. Given the heightened scrutiny and responsibility of members of an SNC, it is appropriate for its members to be comfortable that they will have adequate protections from personal liability and that their litigation expenses will be advanced to them if their decision is judicially challenged. If

gaps are found, they may be able to be addressed.ⁿ⁸ If they can not be addressed, at a minimum, each committee member can decide for himself, based on a more complete understanding of the situation, whether he wants to serve on the SNC.

As with compensation issues, it is important that the issues identified by SNC counsel are resolved early in the process. Putting off the consideration of these questions until late in the process can take on the unfortunate appearance of a *quid pro quo* for a particular committee action or decision. Sometimes, in transactions involving a compressed timeframe, there may not be a significant amount of time between the committee's formation and its ultimate decision. Nonetheless, indemnification and compensation issues should be considered by counsel and discussed with committee members as early as possible.

[5] Chairing the Committee

Which of the committee members will chair the SNC is an important decision. Although all committee members should be actively involved in the business of the SNC, the chairperson sees that the committee runs effectively. The chairperson will often take the lead role in helping to select the SNC's advisors (although all committee members should be involved in that decision) and the chairperson will often be the sounding board for the SNC's advisors between meetings when issues arise. Finally, the chairperson of the committee will often be the person chosen to lead discussions and negotiations if necessary. For this reason, selection of the chairperson is important and ought to be made by the SNC itself rather than by the board establishing the SNC.ⁿ⁹

What characteristics should the chairperson have? Simply, the patience of Job, the wisdom of Solomon and the foresight of a prophet. Lacking a committee member with all of these qualities, the chairperson most typically will be an experienced director who, in one way or another, has significant experience in major corporate transactions of the type under consideration.

[6] Committee Advisors

The selection by the SNC of competent, able advisors is of critical importance to the proper discharge of the SNC's responsibilities. Legal counsel, investment banking advisors, appraisers and other advisors often end up having to take on many more functions in an SNC assignment than they ordinarily would in other types of assignments. For instance, committee members will not necessarily have the full and free access to management that it would if it were simply operating as members of a board of directors. As a result, many functions usually performed by management and staff need to be performed by the advisors. Both the SNC and the advisors need to be aware of this necessity at an early stage.

In almost all instances, the SNC should have the power and authority to hire its own advisors, and it needs to exercise that authority (or, at a minimum, thoughtfully consider whether it needs to hire advisors). Examples abound of situations where advisors were "preselected" by someone other than the SNC--either management or the interested party--which, in turn, compromised the work of the SNC.ⁿ¹⁰ Although it is certainly appropriate for the SNC to ask the company's management for recommendations concerning advisors,ⁿ¹¹ the ultimate decision must be the SNC's.

Two key cases highlight this issue. In *In re Tele-Communications*, a special committee was formed in response to a merger proposal that had the support of the target company's chairman/CEO and its president/COO.ⁿ¹² The special committee decided to retain the same firms that had represented the target company. Of its decision, the Court wrote: "Rather than retain separate legal and financial advisors, the Special Committee chose to use the legal and financial advisors already advising [the target]. This alone raises questions regarding the quality and independence of the counsel and advice received."ⁿ¹³

Less than a year later, the Delaware Court of Chancery revisited this issue in *Gesoff v. IIC Industries*.ⁿ¹⁴ The special

committee in *Gesoff* was formed to assess a cash-out merger proposal from a majority stockholder. Although the one person committee had the authority to choose its own financial and legal advisors, the Court found that "both the special committee's financial and legal advisors were handpicked by [the majority stockholder]."n15 The Court also found the financial advisor to be "actively and persistently disloyal to the special committee and to its aims of ensuring a fair transaction for IIC's minority stockholders,"n16 because it had, without the special committee's knowledge, sent the majority stockholder a "stream of draft valuation reports on which to base his negotiating strategy against the special committee."n17 About this conduit of information between the advisor and the majority stockholder, the Court wrote: "This sieve-like separation between [the financial advisor and the majority stockholder] was obviously inimical to the special committee's power to negotiate a fair transaction."n18 The legal advisor was compromised because he "was beholden for his job to a board entirely dominated by [the majority holder], and had indeed been advising [the majority holder] on its approach to the tender offer from the beginning."n19 The Court concluded that the case presented a "situation in which the special committee's advisors are of little use in establishing the fairness of the merger."n20

Counsel's first task in considering possible retention as SNC counsel is to make sure that he or she understands how he or she came to be considered for retention by the committee. He or she should be sure that the SNC exercised its own judgment in hiring his or her firm and that the decision was not made for the SNC without the SNC's input. Counsel should also be sure to double check his or her and his or her firm's prior or pending involvement with the company and other parties involved in the transaction. Any prior or current representations and their significance to his or her firm should be disclosed to the SNC so that the SNC can decide whether to retain (or continue to retain) the firm. It is not unusual for the SNC to interview more than one law firm in deciding who to hire. This can often be a helpful exercise to the SNC, as it will help to establish the qualifications of the advisor and impose some "price discipline" on the advisors interviewing for the engagement. The committee can also gain different perspectives on its work during the interview process. In other cases, the SNC or members of the SNC will have counsel with whom it has work previously and there is no need to conduct an interview process.

Counsel should work with the SNC and company management in connection with the retention of other advisors. Prior and current engagements of a prospective advisor by the company and others involved in the transaction need to be scrutinized carefully to be sure of the advisor's independence. Recommendations or suggestions by management, although welcome and helpful, should not be followed blindly by the SNC.

The SNC and its advisors should be clear at the outset about the scope of the advisor's duties. This will often first come up in the context of the engagement letter for the advisor, a proposed version of which will, in almost all instances, be provided by the advisor selected by the SNC. The process of negotiating the terms of the engagement letter can be helpful in assisting the SNC and counsel to understand the subtleties and nuances of the SNC process. For instance, the negotiation of the terms of the investment banker's engagement letter will often be the vehicle for defining the banker's role. Will the banker simply be rendering a fairness opinion to the SNC? What is the proper form of the fairness opinion? Does the opinion address fairness from the perspective of the proper group or groups?n21 Will the banker assist the SNC in negotiations? Will the investment banker assist the SNC is assessing broader strategic issues that might be a necessary part of the SNC's work?

The SNC and its counsel should be sure to analyze critically the "boilerplate" provisions in the proposed engagement letter to be sure that it does not include provisions that could compromise the advisor's independence. For instance, the proposed engagement letter from the advisor might contain a provision that would permit the advisor to participate in a financing transaction for either party to the transaction under consideration by the SNC. Obviously the prospect of significant fees from the party on the other side of the transaction, even if only after an agreement has been negotiated and signed, could be seen as comprising the independence of the advisor and its advice to the SNC.n22 The engagement letter should also make clear that the SNC is the advisor's client. This can require some careful drafting because, although the SNC is the client, the company will be paying the advisor's fees and agreeing to indemnify the advisor. In addition, engagement letters will often require affirmative representations and covenants from the company. SNC counsel needs to be sure that the SNC has the authority to cause the company to comply with those representations and

covenants.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Indemnification Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion

FOOTNOTES:

(n1)Footnote 1. Counsel should be sure to review the applicable corporation law and the certificate of incorporation and bylaws of the corporation as they can sometimes impose requirements for the number of directors that must be on a committee. One requirement seen from time to time provides that a board committee have a least two members.

(n2)Footnote 2. One court has described a one person special committee as "oxymoronic and unwise." *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004) , *aff'd*, 872 A.2d 559 (Del. 2005) . *See also Gesoff v. IIC Indus. Inc.*, 902 A.2d 1130, 1149 (May 18, 2006) (finding that the formation of a special committee of one independent director "causes the court to examine the entire process with a higher level of scrutiny, and equally causes the court to require more of [the committee member] than it would had he been joined by other independent directors"). In a case involving an SLC, the Delaware Chancery Court stated that: "If a single member committee is to be used, the member should, like Caesar's wife, be above reproach." *Lewis v. Fuqua*, 502 A.962, 967 (Del. Ch. 1985) .

(n3)Footnote 3. In *In re Tele-Communications*, the Court was troubled by the high fee paid to a special committee and the seemingly contingent nature of that fee. The compensation arrangements for the committee were not decided upon until after the committee approved the transaction. The two committee members were paid \$1 million each for their work, which involved meeting four times over a one-week period. The Court found that the special committee process was flawed in part because of the "suspiciously contingent compensation" paid to its members. *In re Tele-Communications*, 2005 Del. Ch. LEXIS 206, at *34.

(n4)Footnote 4. Assume that an irrevocable decision has been made by the board to "sell the company" so as to maximize the price stockholders of the company are to receive. One might argue that a "success fee" is appropriate in this unusual instance because the interests of the committee members resulting from the fee--getting the highest price in a transaction--are aligned with the interests of the stockholders. However, consider how this type of arrangement could arguably skew the decision of an SNC whether to terminate an agreement that it had approved because of a breach of representation by the party on the other side of the transaction.

(n5)Footnote 5. *See, e.g., In re Tele-Communications*, 2005 Del. Ch. LEXIS 206, at *49.

(n6)Footnote 6. In *In re National Auto Credit, Inc. S'holders Litig.*, CA 19028, 2003 Del. Ch. LEXIS 5 (Jan. 10, 2003) , the Court of Chancery viewed with suspicion an increase in fees paid to a board of directors from \$1,000 per meeting to \$55,000 annually plus an award of stock options, particularly because the increase occurred around the time of the board's approval of a transaction with corporate insiders. In the context of the defendants' motion to dismiss, the court inferred that the increase in fees was a *quid pro quo* for the approval of the transaction.

(n7)Footnote 7. *See Chapter 5 above* discussing statutory limitations on director and officer liability, indemnification and director and officer insurance.

(n8)Footnote 8. For instance, if the corporation's indemnification bylaws do not mandate the advancement of litigation expenses, the committee members can require that the corporation enter into indemnification agreements with the committee members mandating advancement of expenses.

(n9)Footnote 9. A. Sparks and S. Hurd, *Special Negotiating Committees*, 30 Securities & Commodities Regulation 99 (Apr. 23, 1997).

(n10)Footnote 10. *See, e.g., Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) ; *Kahn v. Dairy Mart Convenience Stores, Inc.*, CA 12489, 1996 Del. Ch. LEXIS 38 at *22 n.6. (Del. Ch. Mar. 29, 1996) .

(n11)Footnote 11. *See, e.g., Western Nat'l Corp. S'holders Litig.*, 2000 Del. Ch. LEXIS 82 ("In this case, management merely arranged for the committee to interview advisors that appeared qualified and did not have any connections to" the corporation or the contracting party). *See also In re Emerging Communications, Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 70, at *24 n.6 (June 4, 2004) .

(n12)Footnote 12. 2005 Del. Ch. LEXIS 206 .

(n13)Footnote 13. *Id.* at *41 .

(n14)Footnote 14. 902 A.2d 1130 .

(n15)Footnote 15. *Id.* at 1150 .

(n16)Footnote 16. *Id.* at 1151 .

(n17)Footnote 17. *Id.* at 1152 .

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *Id.* at 1151 .

(n20)Footnote 20. *Id.*

(n21)Footnote 21. *See Levco Alternative Fund Ltd.*, 803 A.2d 428 .

(n22)Footnote 22. *See, e.g., In re Toys "R" Us, Inc., S'holder Litig.*, 877 A.2d 975, 1006 (Del. Ch. 2005) in which the Court stated that the decision of the seller's financial advisor to provide financing to the buyer after the transaction had been effectuated "was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms." The financial advisor asked the seller's permission and the seller acceded to this request. However, the Court opined: "Far better, from the standpoint of instilling confidence, if [the financial advisor] had never asked for permission, and had taken the position that its credibility as a sell-side advisor was too important in this case, and in general, for it to simultaneously play on the buy-side in a deal when it was the seller's financial advisor." *Id.*

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.07

AUTHOR: S. Mark Hurd Andrew M. Johnston

§ 11.07 Committee Meetings and Record-Keeping

[1] Committee Meetings

How meetings of the SNC are to take place may be a function of the corporation's charter or bylaws, which may specify general requirements for board committee's meetings and voting procedures. More often, the bylaws will be silent and the rules and procedures governing SNC meetings will be less than clear. Generally, a majority of the members of an SNC will constitute a quorum for the conduct of SNC business and the SNC will take action on the basis of a majority vote of its members. In some sense, these rules are important because they set forth the requirements for the SNC to take valid action. In another sense, they are inconsequential. Most SNCs act on important matters only if all SNC members are present and only if the SNC members all agree to the particular action: committee action taken on the basis of less than unanimous votes is highly unusual. More routine matters, such as updates to the SNC, can be handled with the participation of less than all of the SNC members' participation.

Many factors will dictate how often meetings will be held. During a lengthy sales process, for instance, it can be important to have regular meetings of the SNC at which the SNC can be apprised of significant developments, even if no decision is required. Often times, well-functioning SNCs with experienced committee members will have important and useful input, even at simple update meetings. Sometimes the advisors may need direction from the SNC on important business points or strategy decisions and, after consultation with the chairperson, a meeting will be called to have the SNC's input on that issue.n1

Much of the business of the SNC can be conducted during telephonic committee meetings, and oftentimes, this is the only practicable way for the SNC to operate, particularly when SNC members and the advisors are located in different parts of the country. However, it is important that meetings at which significant decisions will be made or critical presentations are to be made be held in person if at all possible. There is no substitute for an in-person meeting at which body language and facial expressions can be as evocative as the spoken word.n2

The SNC should take care in controlling who attends its meetings, including meetings with its advisors. In one case, the court found that three independent directors of a corporation who were negotiating an acquisition proposal from the other directors of the corporation (and who were functioning like an SNC) permitted the interested directors to attend

board meetings at which the proposal was discussed and to confer with the independent directors' investment banker.ⁿ³ Although the court was able to determine after trial that the attendance of the interested directors did not influence the independent directors in any way, this issue could have been avoided.ⁿ⁴ A 2005 case also addressed the issue of an interested director, who was also the company's president and CEO, attending special committee meetings.ⁿ⁵ The Court denied defendants' motion to dismiss in part because certain facts, including the interested director's presence at the committee meetings, raised a triable issue as to the independence of the committee.ⁿ⁶

[2] Committee Record-Keeping

It is a reality of the SNC process that many parties may be reviewing the SNC's activities at one time or another and those parties will sometimes question or ask hard questions about the SNC's work and decisions. Depending on the transaction, other board members and management may want to view the SNC's work; the SEC may ask pointed questions about SNC process during its review of preliminary proxy statements submitted by the corporation; a losing bidder in an auction may suggest "unfairness" in the SNC's handling of an auction process; stockholders of the company may demand to know how the SNC reached the decision it did; and committee members may have to answer questions of a plaintiff's lawyer in litigation against the company and the directors at a deposition. In each of these situations, it is important that the SNC and its members have a single, accurate record of the SNC's deliberative process, the information it received in reaching its decision, the reasons for its decision and, of course, its ultimate decision. Accordingly, it is of paramount importance that proper minutes be maintained and that the SNC have a policy or practice in place concerning notes of SNC members.

[a] Minutes

Minutes form the backbone of the record of the SNC's deliberations. Given their importance, there is surprisingly little written about minutes and how they should be kept. Responsibility for the preparation of minutes almost always falls to the SNC's counsel. Although it might seem extravagant to some, it is good practice for a lawyer to attend the meeting whose sole job it is to take notes of the meeting that will form the basis of the minutes. It is too difficult for one person to attend a meeting for the dual purposes of advising the SNC, which necessitates his or her undivided attention to presentations and discussions, and recording accurately the discussions as they take place. There is simply too much potential for one of the two functions to be short changed. The lawyer's notes will then be the basis for the preparation of drafts of minutes of the SNC's meeting.

Counsel have different styles of minutes. Some prefer short form minutes that simply recite that the committee met, received a presentation from XYZ Investment Banking Firm, deliberated and then reached a decision. Although there may be a place for this style of minutes, it is preferable to keep more detailed minutes that reflect, for instance, the important elements of the presentations made to the SNC, material advice that the SNC received from counsel, the various facts and factors weighed by the SNC in its deliberations, and the SNC's decision and reasons for its decision. Although it is not necessary (or desirable) to have minutes that are a transcript of the meeting, it is better to err on the side on more detail than less.ⁿ⁷

Clements v. Rogers,ⁿ⁸ highlights the importance of proper minutes. *Clements* involved a merger in which Texas Industries, Inc. acquired the 16 percent of the equity of Chaparral Steel Company it did not own. A special committee of the board of directors of Chaparral was appointed to negotiate the purchase price for the shares. The negotiations took place over a period of several months during the summer of 1997. The merger agreement was approved at the end of July, 1997. A proxy statement for the transaction was issued at the end of November 1997 and the merger closed at the end of December 1997. Plaintiff filed her suit in May of 1997. After some preliminary discovery, she amended her complaint on May 26, 1999. After additional discovery, plaintiff filed another amended complaint and defendants thereafter moved for summary judgment. Depositions of the committee members were taken during the summer of 2000, three years after the negotiations had taken place. By that point, the chairperson of the special committee was in his early eighties. His deposition testimony, as described by the court, was sufficiently confused and unclear on several

important points that the court refused to grant the defendants' summary judgment motion in full. The court suggests that the chairperson's deposition testimony might "simply result [] from memories rusty from disuse."⁹

Nothing in the court's decision suggests that inadequate minutes were taken. Indeed, minutes were probably part of the record support for the court's observation that: "There is record evidence that suggests that when all is said and done, the Special Committee and its advisors will be found to have acted vigorously, informedly, and effectively ..." ¹⁰ However, this case is the type of instructional case that highlights the reasons why good minutes can be so important: the memories of witnesses may become "rusty" or the witnesses may be unavailable for a variety of reasons, including disability, sickness or death. Without minutes that will help refresh the memories of "rusty" witnesses or that, standing alone, provide the trier of fact with details of the SNC's work that missing witnesses can not, the possibility of personal liability and damages becomes more likely and the potential for personal embarrassment to the SNC members becomes greater.

Ideally, draft minutes should be circulated for review by meeting participants reasonably promptly after the meeting, while memories are fresh.¹¹ In other cases, it may be prudent to wait until after another meeting has taken place before draft minutes of the prior meeting are circulated for approval. Sometimes points or themes that were not clear in the first meeting may become clearer in the second, and the minutes of the first meeting can be prepared to place appropriate emphasis on those facts or themes. In some cases, circumstances may dictate a prompt preparation and circulation of draft minutes. For instance, the negotiation of a transaction may be moving so quickly that the other parties to the transaction may, as a matter of their due diligence, require an opportunity to review committee meeting minutes prior to entering into a transaction.¹²

[b] Note Taking by Committee Members

Litigators are fond of saying that the surest way for an SNC member to have his or her deposition taken first and to have that deposition last the longest is to take and keep copious notes. There is a kernel of truth in this adage. Almost by their nature, the notes taken by SNC members during a meeting will be cryptic and incomplete and therefore subject to varying interpretations. It is the possible varying interpretations that plaintiff's counsel will want to explore at a deposition (and perhaps later exploit in the litigation). Some will advise SNC members not to take notes at all. However, to some SNC members, note taking is an important part of their deliberative process and placing artificial limitations on note taking can inhibit the effective functioning of the SNC. For this reason, more important than the issue of note taking is note retention. SNC members should be advised that, prior to the time that litigation is commenced challenging the SNC's decision or the transaction it approved, if they need to take notes, they should feel free to do so. However, once they are finished with the notes, the notes should be discarded.¹³ Assurances to the SNC members that the minutes will accurately reflect the SNC meetings should help dissuade members from taking *and keeping* notes that simply outline the meeting. As a result, notes that SNC members do take should simply be questions that they may have or points or issues that appear to require clarification or further discussion. Once questions have been answered and the discussion has taken place, SNC members should be comfortable that they no longer need the notes and that they can safely be discarded.

[c] Materials Distributed to the Committee

In many cases, materials distributed to the SNC, such as presentation books prepared by the investment bankers, drafts of material agreements and summaries thereof, and memos from counsel addressing legal issues, will be distributed to SNC members in advance of the meeting. These materials should be prepared with the expectation that they may have to be made available to, or described to, stockholders with or in proxy statements or other disclosure documents. The SEC has in recent years insisted in many situations that investment banker board books, even those that are in draft form, distributed to SNC members be filed with the SEC or described in the disclosure document being prepared.¹⁴

Every effort should be made to distribute materials to the SNC members sufficiently in advance of a meeting that they

will have an opportunity to study the materials. In this way, SNC members can come to the meeting with adequate background for an effective meeting. Advance distribution will make it less likely that SNC members will want to take materials with them following the meeting. Care should be taken regarding how information is disseminated to committee members. For example, in *Emerging Communications*, the chairperson of the committee routed all of his correspondence to the other committee members through the controlling stockholder's secretary, thereby giving the controlling stockholder "access to the committee's deliberations and strategy."¹⁵ The Chancery Court cited this action as one of the factors rendering the SNC ineffective.

Occasionally, it is not possible to get materials to SNC members in advance of the meeting. In these circumstances, counsel should consider ways to have the SNC informed about the contents of the documents. In some cases, executive summaries of the documents can be prepared for the SNC and the meeting can be briefly adjourned to enable the SNC members the chance to review the summary. Having counsel review the relevant document in more detail than usual at the meeting is another option.

After the meeting, what should be done with materials given to committee members? Sometimes SNC members will want to take a copy with them for further study and review. If SNC members find this necessary, they should be asked to return the materials when they are done with them. In such circumstances, counsel may wish to note which SNC members take materials with them and to follow up on the return of the materials at a later date.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion Business & Corporate Law Corporations Directors & Officers Scope of Authority Meetings Procedures Business & Corporate Law Corporations Governing Documents & Procedures Records & Inspection Rights Recordkeeping

FOOTNOTES:

(n1)Footnote 1. Here again, the important role of the chairperson is highlighted. He or she will have to know his or her fellow committee members, and be able to judge whether a particular issue about which the advisors consult him or her is one on which the committee members may want input.

(n2)Footnote 2. Jeff Bezos, the CEO of Amazon.com, the well-known internet retailer, stated during an interview, in response to a question about his company's board meetings, that: "We are a little old-fashioned in this respect. There's nothing better than an in-person meeting. Nothing yet has replicated that as far as I know. For quick interaction, e-mail and phone are great. But for really getting into something, a physical meeting is much better." *Taming the Out-of-Control In-Box*, Wall St. J., Feb. 4, 2000, at 134. See also *In re Emerging Communications, Inc. S'holders Litig.*, 2004 Del. Ch. LEXIS 70, at *6 (June 4, 2004) (noting that the committee's failure to have met collectively in person or even by phone prevented the committee from functioning).

(n3)Footnote 3. *Emerald Partners v. Berlin, CA 9700, 2003 Del. Ch. LEXIS 42 (Apr. 28, 2003)* .

(n4)Footnote 4. Careful minute taking can be helpful with an issue like this. For instance, the minutes can record, if true, that particular individuals attended the meeting at the invitation of the SNC or note the point in the meeting at which particular individuals joined, or were excused from, the meeting.

(n5)Footnote 5. *In re Freeport-McMoran, 2005 Del. Ch. LEXIS 96* .

(n6)Footnote 6. *Id. at *13*.

(n7)Footnote 7. Of course, one of the burdens associated with having detailed minutes is that they be accurate. The

burden for accuracy will typically fall on counsel, although as discussed *below*, input from the SNC and other participants in the meeting can be important as well.

(n8)Footnote 8. *Clements v. Rogers*, 790 A.2d 1222 (Del. Ch. 2001) .

(n9)Footnote 9. *Clements*, 790 A.2d at 1231 .

(n10)Footnote 10. *Clements*, 790 A.2d at 1231, n.14 .

(n11)Footnote 11. The Court in *In Re Netsmart* took a jaundiced view of minutes from ten meetings that were approved all at once and after some time had passed. The Court wrote: "After this litigation commenced, the Special Committee met on December 21, 2006 and approved formal minutes for ten meetings ranging from August 10, 2006 through November 28, 2006. That tardy, omnibus consideration of meeting minutes is, to state the obvious, not confidence-inspiring... ." 924 A.2d at 191 .

(n12)Footnote 12. This may not always be appropriate, particularly before a transaction is signed or completed, as the minutes may disclose negotiating positions, reserve prices and other sensitive information that, until the transaction has been completed, would not be appropriate for the counter party to know. Of course, this information need not be included in the minutes in the first instance.

(n13)Footnote 13. The appropriate procedures to follow after litigation has commenced will vary from jurisdiction to jurisdiction and litigation counsel should be consulted in each case.

(n14)Footnote 14. Sommer, Jr., *Securities Law Techniques*, § 65.06[4], at 65-82-65-83 (LexisNexis Matthew Bender).

(n15)Footnote 15. *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *34.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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Corporate Governance: Law and Practice

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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.08

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§ 11.08 An Overview of Special Committees in the Litigation Context

Derivative lawsuits are a significant exception to the general principle that the board of directors manages the corporation's business and affairs, but special committees of directors can still be used in certain instances to avert threatened litigation or to take from the stockholder-plaintiff the right to prosecute a properly-filed derivative complaint. Two fundamental predicates of derivative litigation are "standing" and the "demand" requirement. After examining these two predicates of derivative litigation, the balance of this chapter examines the use of a special committee of independent directors in two common contexts: (1) responding to a stockholder demand that the board take action to redress perceived harm to the corporation; and (2) investigating and making a determination regarding claims asserted by a stockholder in a derivative complaint.

[1] What are the Requirements for Stockholder Standing?

Each of the American Bar Association's Model Business Corporation Act ("ABA Model Business Act"), the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations ("ALI Principles of Corporate Governance") and the Delaware General Corporation Law imposes a "continuous ownership" requirement upon any stockholder who wishes to assume the role of a derivative plaintiff. To have standing under the ABA Model Business Act to commence a derivative proceeding, the stockholder must: (1) have held shares at the time of the allegedly wrongful act or omission (or have become a stockholder through transfer by operation of law from one who held shares at such time) and continue to be a stockholder throughout the litigation, and (2) fairly and adequately represent the interests of the corporation.ⁿ¹

Under the ALI Principles of Corporate Governance, the stockholder also must fairly and adequately represent the interests of the stockholders. The requirement of continuous ownership under the ALI Principles of Corporate Governance may be excused if the failure to continue holding shares "is the result of corporate action in which the holder did not acquiesce, and either (1) the derivative action was commenced prior to the corporate action terminating the holder's status, or (2) the court finds that the holder is better able to represent the interests of the shareholders than any other holder who has brought suit."ⁿ²

Delaware General Corporation Law § 327 requires that the stockholder-plaintiff includes in the complaint an allegation

that the "plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law."³ The purpose of the standing requirement is to prevent persons from purchasing stock for the purpose of maintaining a derivative action challenging a transaction that occurred before the purchase of stock in the corporation.⁴ Not unlike the ALI Principles of Corporate Governance, the stockholder under Delaware law also must be qualified to serve in a fiduciary capacity as a representative of the other stockholders.⁵ Delaware law accords to both record stockholders and beneficial owners standing to prosecute a derivative action,⁶ and recognizes stockholder standing to challenge a continuing transaction that is not consummated before the plaintiff acquired stock.⁷

[2] When Is a Demand Required?

In certain jurisdictions, a stockholder with standing must first make a demand before commencing a derivative lawsuit and, in other jurisdictions, a stockholder must either make a demand and allege facts establishing that the demand was wrongfully refused or allege facts establishing that demand should be excused as futile. Compliance with the demand requirement generally is governed by the law of the state of incorporation.⁸

A "demand" often takes the form of a letter, frequently from the stockholder's counsel, raising concerns about recent events and demanding that the corporation's board of directors take action against certain identified individuals to redress an alleged harm to the corporation.⁹ The demand requirement seeks to balance the right of the directors to manage the corporation's business against the rights of stockholders when a corporation unjustifiably fails to act for itself.

[a] How Do Courts Distinguish between Derivative and Direct Claims?

The ABA Model Business Act, the ALI Principles of Corporate Governance and the Delaware General Corporation Law all recognize that the demand requirement applies only to derivative claims belonging to the corporation, and not to direct claims belonging to the stockholders individually.¹⁰ In distinguishing derivative from direct claims, the ABA Model Business Act simply provides that a derivative proceeding is one "in the right of" the corporation.¹¹ Section 7.01 of the ALI Principles of Corporate Governance provides more guidance, explaining that a derivative action is one brought "to redress an injury sustained by, or enforce a duty owed to, a corporation. An action in which the holder can prevail only by showing an injury or breach of duty to the corporation should be treated as a derivative action." Section 7.01 further provides that in the case of a closely held corporation, the court "may treat an action raising derivative claims as a direct action... ." ¹²

The Delaware Supreme Court revisited the approach for distinguishing between derivative and direct claims in 2004. In *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*,¹³ the court concluded that certain concepts in Delaware jurisprudence for distinguishing between direct and derivative claims were "not helpful" and held that the analysis "must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"¹⁴ Accordingly, Delaware law will no longer look for the existence of "special injury" as the basis for determining that a claim is direct.

Notwithstanding the newly-refined approach in *Tooley*, practitioners and courts likely will continue to struggle to determine whether claims are derivative or direct, especially in the context of mergers, where there is a "thin grey line" separating direct challenges to the merger itself from wrongs associated with the merger that harm the corporation.¹⁵ The analytical difficulty associated with distinguishing between direct and derivative claims in the context of a merger is significant not only to whether the stockholder is required to make a demand but also to the fundamental question of whether the plaintiff has standing to prosecute the claim. If the claim associated with a merger is derivative, the plaintiff generally loses standing to prosecute the claim upon the merger's closing because he or she ceases to be a stockholder of the corporation.¹⁶

[b] Universal Demand States

Under both the ABA Model Business Act and the ALI Principles of Corporate Governance, a demand is required in all cases, unless making demand would result in irreparable injury to the corporation. Advocates of this "universal demand" argue that it promotes the principle that directors should govern the corporation's business and affairs by encouraging corrective action that may moot the need for litigation altogether and that, in all events, it eliminates threshold litigation regarding whether demand was required.

Many states have adopted statutes requiring universal demand and Pennsylvania has, by court decision, adopted such a requirement.ⁿ¹⁷ Although each imposes a universal demand requirement, the ABA Model Business Act and the ALI Principles of Corporate Governance adopt differing standards of judicial review of a corporation's response to a demand. The ABA Model Business Act generally establishes pleading rules and allocates the burden of proof depending on the composition of the board of directors. Judicial review under the ALI Principles of Corporate Governance varies depending on the nature of the alleged wrongdoing. If the underlying transaction or conduct would be governed by the business judgment rule or constitutes a breach of the duty of care, the court should dismiss the action unless the determination to refuse the demand fails to satisfy the requirements of the business judgment rule.ⁿ¹⁸ In cases where the business judgment rule is not applicable or in which a breach of the duty of fair dealing is at issue, the court should dismiss if the court concludes the board or committee was adequately informed "and reasonably determined that dismissal was in the best interests of the Corporation," based on grounds that the court deems to warrant reliance.ⁿ¹⁹ Dismissal is prohibited if the plaintiff establishes that a defendant would be permitted "to retain a significant improper benefit" where the defendant, alone or with others who received an improper benefit, possesses control of the corporation, or if the benefit was obtained through a "knowing and material misrepresentation or omission" or without "advance authorization or the requisite ratification of such benefit by disinterested directors...".ⁿ²⁰

[c] Delaware

[i] Demand Excused

Under Delaware law, the demand requirement generally is excused when one-half or more of the corporation's directors are "incapable of making an impartial decision regarding such litigation."ⁿ²¹ When challenging a decision of the board of directors, demand will be excused if the plaintiff alleges particularized factsⁿ²² creating a reasonable doubt regarding (1) director disinterest or independence or (2) whether the directors exercised proper business judgment in approving the transaction.

Director interest is established by particularized facts demonstrating a material financial interest in the challenged decision or an entrenchment motive. Lack of independence exists when directors are beholden to or otherwise controlled by a person with an interest in the transaction. As the Delaware Supreme Court recently explained in a high-profile case involving Martha Stewart, independence is a "contextual inquiry" that *requires* courts to consider whether a particular relationship "is so close that the director's independence may *reasonably* be doubted."ⁿ²³

Particularized facts that, if proven, would constitute gross negligence on the part of the directors also will excuse demand. In circumstances when the challenged conduct does not involve an actual business decision by the board, the complaint must contain particularized factual allegations creating a reasonable doubt that, at the time the complaint was filed, a majority of the directors could have exercised independent and disinterested business judgment in responding to the subject of the complaint.

[ii] Demand Wrongfully Refused

The making of a demand under Delaware law is significant because once "made, absent a wrongful refusal, the

stockholder's ability to initiate a derivative suit is terminated."²⁴ The stockholder must give the directors "an adequate and reasonable amount of time" to respond to the demand,²⁵ the making of which operates as a concession that a majority of the corporation's directors is disinterested and independent with respect to the subject of the demand. A court's analysis of whether a complaint should be dismissed following a demand is therefore limited to the "good faith and reasonableness" of the investigation.²⁶ In short, the only issue the court addresses on a motion to dismiss a complaint filed following a stockholder demand is "the application of the traditional business judgment rule to the Board's refusal of [the] demand."²⁷

By making a demand, a stockholder does not, however, "waive the right to claim that demand has been wrongfully refused."²⁸ Nor will the decision of one stockholder to make a demand affect another stockholder's right to argue that demand is excused as futile.²⁹ As in the demand excused context, naming a majority of the directors as defendants and advancing conclusory allegations of laxity or conspiracy, are insufficient to establish that a demand was wrongfully refused.³⁰ Conclusory allegations that the corporation's board "did nothing" and refused to permit plaintiff's counsel to make a presentation regarding the subject of the demand likewise are insufficient to establish that demand was wrongfully refused.³¹

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsShareholdersActions Against CorporationsDerivative ActionsGeneral OverviewBusiness & Corporate LawCorporationsShareholdersActions Against CorporationsDerivative ActionsProceduresBusiness & Corporate LawCorporationsShareholdersActions Against CorporationsStandingDemand FutilityCivil ProcedureClass ActionsDerivative ActionsDemand FutilityCivil ProcedureClass ActionsDerivative ActionsDemand Requirement

FOOTNOTES:

(n1)Footnote 1. ABA Model Business Act § 7.41 (Official Text 2005).

(n2)Footnote 2. ALI Principles of Corporate Governance: Analysis and Recommendations § 7.02(a) (1994).

(n3)Footnote 3. *Del. Code Ann. tit. 8, § 327*.

(n4)Footnote 4. *See, e.g., Newkirk v. W.J. Rainey, Inc., 31 Del. Ch. 433, 76 A.2d 121 (Del. Ch. 1950)* .

Stockholders cannot, however, evade the standing requirement by claiming that the statute's purpose does not apply to them. *Desimone v. Barrows, 924 A.2d 908, 926 (Del. Ch. 2007)* ("Although this court has often recognized that a primary purpose of § 327 is to prevent plaintiffs from buying stock in order to maintain a derivative suit, there is no indication in the unambiguous text of the statute that that is its only purpose or that a plaintiff has standing when he otherwise would not simply because he was ignorant of the wrongdoing before he acquired stock.").

(n5)Footnote 5. *Youngman v. Tahmoush, 457 A.2d 376 (Del. Ch. 1983)* .

(n6)Footnote 6. *Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A.2d 106 (Del. Ch. 1948)* .

(n7)Footnote 7. *Newkirk, 31 Del. Ch. 433, 76 A.2d 121* .

(n8)Footnote 8. *Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 96-97, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991)* . *See also* ABA Model Act § 7.47.

(n9)Footnote 9. *See, e.g., Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988)* . A letter that demands remedial action by the corporation that would mainly benefit the letter writer may not qualify as a proper demand. *Khanna, (Del. Ch. May 9, 2006)* (finding further that any ambiguity as to the letter's purpose should be

resolved in favor of plaintiff, who claimed the letter was not a demand).

(n10)Footnote 10. The distinction is significant because of heightened pleading requirements applicable to derivative claims and because certain defenses and procedural mechanics like a special litigation committee apply only to derivative claims.

(n11)Footnote 11. ABA Model Business Act § 7.40.

(n12)Footnote 12. ALI Principles of *Corporate Governance* § 7.01(d).

(n13)Footnote 13. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031(Del. 2004) .

(n14)Footnote 14. *Tooley*, 845 A.2d at 1033 (emphasis in original).

(n15)Footnote 15. See, e.g., *Turner v. Bernstein*, CA 16190, 1999 Del. Ch. LEXIS 18, at *39 (Del. Ch. Feb. 9, 1999) ; *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999) . *Gatz v. Ponsoldt*, 925 A.2d 1265, 1277-81 (Del. 2007) (challenge to recapitalization could be brought as a direct claim); *Rhodes v. Silk Road Equity, LLC, C.A. No. 2133-VCN*, 2007 Del. Ch. LEXIS 96 (Del. Ch. July 11, 2007) (unfair purchase of assets could be challenged in a direct claim).

(n16)Footnote 16. See, e.g., *Behrens v. Aerial Communications, Inc.*, CA 17436, 2001 Del. Ch. LEXIS 80, at *19-20 (Del. Ch. May 18, 2001) ; *Lewis v. Ward*, 852 A.2d 896 (Del. 2004) .

(n17)Footnote 17. See *Ariz. Rev. Stat. § 10-742; Conn. Gen. Stat. § 33-722; Fla. Stat. Ann. § 607.07401(2); Ga. Code Ann. § 14-2-742; Me. Rev. Stat. Ann. tit. 13-C § 753; Mich. Comp. Laws § 450.1493a(a); Miss. Code Ann. § 79-4-7.42; Mont. Code Ann. § 35-1-543; Neb. Rev. Stat. Ann. § 21-2072; N.H. Rev. Stat. Ann. § 293-A:7.42; N.C. Gen. Stat. § 55-7-42; Tex. Bus. Corp. Act § 5.14(C); Va. Code Ann. § 13.1-672.1B(1); Wis. Stat. § 180.0742; see also *Cuker v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042, 1048-49 (Pa. 1997) . Many states have modified the model language and, accordingly, practitioners must review the specific statutory provisions applicable to their corporate clients.*

(n18)Footnote 18. ALI Principles of Corporate Governance, § 7.10(a)(1).

(n19)Footnote 19. ALI Principles of Corporate Governance, § 7.10(a)(2).

(n20)Footnote 20. ALI Principles of Corporate Governance, § 7.10(b).

(n21)Footnote 21. *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993) ; see also *Beam v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004) .

(n22)Footnote 22. Delaware courts repeatedly have advised plaintiffs attempting to plead demand futility to use the "tools" of a demand for books and records under Section 220 of the DGCL to develop facts needed for a particularized complaint. See, e.g., *Beam*, 845 A.2d at 1056 .

(n23)Footnote 23. *Beam*, 845 A.2d at 1050 , 1051 (emphasis in original).

(n24)Footnote 24. *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990) (internal quotation omitted).

(n25)Footnote 25. *Smachlo v. Birkelo*, 576 F. Supp. 1439, 1445 (D. Del. 1983) .

(n26)Footnote 26. *Spiegel*, 571 A.2d at 777; *Scattered Corp. v. Chicago Stock Exch., Inc.*, CA 14010, 1996 Del. Ch. LEXIS 79, at *9 (Del. Ch. July 12, 1996) , *aff'd*, 701 A.2d 70 (Del. 1997) .

(n27)Footnote 27. *Levine v. Smith*, 591 A.2d 194, 212 (Del. 1991) , *overruled on other grounds*, *Brehm v. Eisner*,

746 A.2d 244 (Del. 2000) .

(n28)Footnote 28. See *Scattered*, 701 A.2d at 74.

(n29)Footnote 29. See *Avacus Partners, L.P. v. Brian*, CA 11001, 1990 Del. Ch. LEXIS 178, at *29-30 (Del. Ch. Oct. 24, 1990) .

(n30)Footnote 30. See *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1054-1055 (Del. Ch. 1996) .

(n31)Footnote 31. *Levine*, 591 A.2d at 213-214.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.09

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§ 11.09 The Demand Investigation or Evaluation Committee

[1] Was There a Demand?

How does a corporation or its legal advisor determine if a communication from or on behalf of a stockholder of the corporation constitutes a "demand"? Although a stockholder demand need not assume a particular form, at least some courts have concluded that it must be directed to the board as a whole--not solely to the board's chair or to the corporation's general counsel--and must identify the stockholder.ⁿ¹

To constitute a demand, courts generally have held that the communication must "identify the alleged wrongdoers, describe the factual basis of the wrongful acts and the harm caused to the corporation, and request remedial relief."ⁿ² The burden of proving that a demand has been made rests upon the party claiming that there was a demand and, absent a proper demand, the corporation need not respond.ⁿ³ Because of the "weighty consequences" of making a demand, Delaware courts have determined that the communication must "clearly and specifically" satisfy each of the requirements for a demand and, accordingly, they will not construe "ambiguous communications" to be demands.ⁿ⁴

[2] Forming the Demand Investigation or Evaluation Committee

Once a board and its advisors have determined that the board has received a demand, there are a variety of available options. Merely declining to take a position with respect to the demand, however, is not one of them because the failure to take a position will be "viewed as tacit approval for the continuation of the litigation."ⁿ⁵ A corporation, or in appropriate circumstances a special committee of its board,ⁿ⁶ can: (1) accept the demand and prosecute the action on behalf of the corporation, (2) permit the stockholder to prosecute the claims contained in the demand, (3) resolve the grievance internally without resort to litigation, or (4) refuse the demand.

[a] Who Should Be on the Committee?

In determining the membership of a demand investigation or evaluation committee, the board should avoid appointing persons who are alleged in the demand to have committed some wrong, as well as any other person with a financial interest in the challenged action. To the extent possible, directors who participated in the action and persons whose independence is subject to challenge should not be members of the committee.

Mere approval of a challenged transaction, however, does not disable a director from investigating or evaluating a demand.ⁿ⁷ Moreover, so long as a committee is given only the authority to make a recommendation, and not the authority to act on the demand, its members may include non-directors, an exception to the requirements for the composition of other types of special committees.ⁿ⁸

[b] What is the Appropriate Scope of Authority?

If the board determines to form a special committee, corporate formalities, including relevant provisions of state law and the corporation's charter and bylaws, must be observed. Board resolutions appointing the committee should set forth the scope of the committee's authority (*e.g.*, to investigate or evaluate the matters set forth in the demand and make a recommendation to the full board), empower it to retain, at the corporation's expense, independent legal and other advisors to assist it in the investigation, grant the committee access to any information it requests, instruct the corporation's employees and agents to cooperate with the committee, and compensate and potentially provide for indemnification of the individuals who serve as members of the committee. Because a demand operates as a concession that a majority of the board is disinterested and independent, there is little incentive under Delaware law to vest the demand investigation or evaluation committee with final decision-making authority with respect to the substance of the demand.

[c] The Retention of Counsel

If the directors already have sufficient information regarding the subject of the demand, a formal investigation may not be required. Generally, however, one of the committee's first tasks will be to engage qualified counsel to assist the committee. Although that assistance may in certain minor matters be provided by the corporation's in-house or regular outside counsel, in circumstances where the subject matter of the demand involves claims against senior management, the committee should retain special counsel experienced in the representation of special committees and whose independence from management cannot reasonably be challenged. Although counsel that has represented the alleged wrongdoers with respect to the subject of the demand obviously should not be engaged by the demand investigation committee,ⁿ⁹ counsel that regularly has represented the corporation also should be avoided as the prior relationship may cause a reviewing court to question counsel's independence.ⁿ¹⁰

Early in the representation, counsel should provide to the committee members an overview of their duties in investigating or evaluating the demand. This advice may be given orally, but directors who are new to the process often appreciate a written overview of their duties. Rather than devote the time and expense to the preparation of a memorandum for the committee, discovery of which later may be permitted by a court, a publicly available article authored by recognized authorities that describes issues applicable to the use of a special committeeⁿ¹¹ may provide a cost-efficient means of educating the committee members. The committee also must be advised of the importance of confidentiality during its investigation, and should avoid discussion with management or other directors regarding the investigation or the committee's tentative conclusions.

The committee and its counsel also should consider whether the assistance of other advisors, such as accounting or financial experts, will be required. The goal for counsel representing a demand investigation or evaluation committee is to assist its members in determining how "best to inform themselves of the facts relating to the alleged wrongdoing and the considerations, both legal and financial, bearing on a response to the demand."ⁿ¹²

[3] The Investigation or Evaluation Process

There is no universally prescribed procedure for investigating or evaluating a demand. As a general matter, however, the directors charged with such a task often conduct a factual investigation, described in more detail below, so as to assess the merits of the claims of alleged wrongdoing. In addition to the merits, the committee also may consider other,

non-legal factors such as commercial, promotional, public relations and employee morale concerns.

[a] Issues of Timing

Once the corporation determines who will investigate or evaluate the allegations made in the demand, the stockholder or counsel to the stockholder should be advised of that decision. If possible, the stockholder or counsel also should be given an indication of when a further response to the demand may be expected. In cases where the issues are complex, it may be advisable to communicate only that a committee has been appointed and that the committee or its advisors will notify the stockholder's counsel within 30 days of the expected timetable for the investigation.

Under Delaware law, the board is entitled to a "reasonable amount of time" to respond to a demand.¹³ The amount of time that is reasonable varies depending on the number of alleged wrongdoers, the length of the alleged wrongdoing and the "complexity of the technological, quantitative, and legal issues raised by the demand."¹⁴ If a complaint is filed before a reasonable time to respond has elapsed, the court either will dismiss it as premature (with leave to refile) or stay the action.¹⁵

[b] Collecting and Reviewing Documents

Among the first things the committee and its counsel should do is to identify and collect copies of any relevant documents, including any that the stockholder or the stockholder's counsel believes the committee should consider. Among the documents that should be collected are minutes of any board or committee meetings that pertain to the subject matter of the demand, any documents distributed at such meetings and, for SEC-reporting corporations, relevant public filings. Other materials that may be helpful include press releases, closing binders, due diligence schedules and analyst reports. These documents will help the committee make preliminary determinations regarding the identity of potential witnesses, the potential merits of the claims and the prospect that the corporation was injured by the alleged wrongdoing.¹⁶ Because the committee frequently will need documents in the possession of various corporate personnel and third parties, counsel to the committee investigating or evaluating a demand often will need to develop a written, easily understood request for other categories of documents.

Very early in the process, counsel to the committee will need to meet with one or more knowledgeable members of the corporation's management, often the general counsel, regarding the corporation's record keeping system (including electronic materials such as e-mail), the corporation's document retention and destruction policies, and the most efficient way to locate relevant documents. When the relevant documents are voluminous, counsel will need to adopt procedures applied in litigation to manage the document production, including keeping a record of what files have been reviewed and placing identification numbers on documents.

[c] The Interview Phase

Following the collection and review of relevant documents, the demand investigation or evaluation committee and its counsel typically will proceed to identify persons to be interviewed.¹⁷ While the putative wrongdoers should almost always be interviewed, the number and identity of other witnesses will necessarily vary depending upon the nature of the claims and issues identified in the documents. The committee should exercise its judgment to determine which persons should be interviewed, and need not interview each person who has knowledge of the subject matter. Thought should be given to requesting an interview of the stockholder or the stockholder's counsel who made the demand.¹⁸ Face-to-face meetings provide a better opportunity to assess demeanor and credibility, and facilitate the use of documents. To the extent possible, interviews should be conducted in a location where the witness is comfortable, and not distracted by work or other matters.

Counsel should prepare for interviews in much the same way as they would prepare for a deposition, thoroughly reviewing relevant documents and preparing an outline of the subjects of inquiry. Committee counsel should begin the

interview itself with explanations of the reason for the interview, that counsel represents the committee and not the interviewee,ⁿ¹⁹ and that the interviewee has the option of having his or her own counsel present. To protect the confidentiality of the process, the committee's counsel also should encourage interviewees not to discuss the interview with others. Although the demand investigation committee lacks subpoena power, most relevant witnesses generally are willing to cooperate because they will either be employees of the corporation or third parties who were retained or engaged to provide services to the corporation.

Although it may be appropriate to have an interview recorded, interviews frequently occur without a court reporter or other recording because the absence of a reporter or other recording tends to encourage the free-flow of information and permits the committee and counsel, at a later date, to pose follow-up questions. Committee counsel should take notes during the interview process and use those notes to create a written summary of the interview, copies of which should be shared with the committee members for their comments or questions.

[d] Record-keeping

Meetings of the committee often may be held telephonically and should be conducted like other board meetings with minutes of each meeting kept by counsel to the committee.ⁿ²⁰ Counsel should, after advising committee members of their legal obligations, attempt to encourage active participation in the committee's processes, which will improve the quality of the investigation and assist the decision-making process.

When the investigation or evaluation is sufficiently complete that the committee may begin its preliminary assessment of a response to the demand, counsel should emphasize that preliminary conclusions are subject to revision or change based on the continuing investigation, and help the committee members identify relevant considerations in their analysis, including the extent of any damage to the corporation, the likelihood of recovering for such injury weighed against the direct and indirect costs of seeking redress, and other available remedial options.ⁿ²¹

In circumstances where a demand investigation committee has been formed to make a recommendation to the full board of directors regarding a demand, the committee and counsel must consider how they want to document the committee's conclusions and recommendation, and how the recommendation should be presented to the full board. Often, especially when the issues are serious or complex, the committee's conclusions and recommendation will be included in a written report. While the precise contents of the committee's report will vary significantly depending on the unique facts of each investigation, the report generally should include a description of the claims made in the demand, the nature and scope of the committee's investigation, including documents reviewed and witnesses interviewed by the committee or its counsel, a discussion of applicable legal standards, a comprehensive recitation of the committee's factual findings and reasons for its recommendation regarding the claims asserted in the demand.

After the committee completes its report and reaches its recommendation regarding the demand, the committee and its counsel must determine how to communicate the committee's conclusions and recommendation to the full board. Copies of the report often will be provided to the board of directors and a meeting date set for the committee to present its recommendation. If the board accepts the committee's recommendation, the corporation must determine what amount of detail regarding the decision should be communicated to the stockholder.

[4] How Will Courts Review the Committee's Recommendation?

As noted above, a demand investigation or evaluation committee can recommend that the corporation accept and prosecute the demand, permit the stockholder to prosecute the litigation, resolve the grievance internally or refuse the demand. In the first two situations, there is little chance a court will review the committee's recommendation because the stockholder is unlikely to challenge it.

If the committee recommends internal resolution of the issues raised in the demandⁿ²² or recommends that the demand

be refused, the stockholder may seek judicial review. Under the ABA Model Business Act and the ALI Principles of Corporate Governance, both of which require that a demand be made, differing standards of judicial review may be applied to the decision to refuse a demand, based in part on the independence of the board or the committee and the nature of the alleged wrongdoing. Under Delaware law, if the board appoints a committee to investigate the demand and make a recommendation to the full board, the court considers the good faith and reasonableness of both groups.ⁿ²³ The court may consider the contents of a board letter refusing the demand and must, absent particularized allegations rebutting the truth of its contents, presume its statements are true.ⁿ²⁴

Cases applying this standard have concluded that the board's refusal to permit plaintiff's counsel to make a presentation regarding the claims did not make a refusal wrongful, nor did the refusal to provide a copy of the report to plaintiff's counsel.ⁿ²⁵ Similarly, allegations that the letter refusing the demand was drafted and signed by counsel, failed to indicate that the directors had met to consider the demand, failed to respond to each allegation of the demand and was dated only nine days after the demand, are insufficient to survive a motion to dismiss.ⁿ²⁶ Allegations of reliance upon counsel to the alleged wrongdoers, however, may be sufficient to withstand a motion to dismiss on grounds that the demand was wrongfully refused.ⁿ²⁷

Under Delaware law, a stockholder who makes a demand generally is not permitted any discovery in opposing a motion to dismiss for failure to allege specific facts showing that the demand was wrongfully refused.ⁿ²⁸ Despite the general prohibition on discovery, however, Delaware law recognizes, through Delaware General Corporation Law § 220, a possible method for the stockholder to avoid the prohibition on discovery where a demand has been made.

In *Grimes v. DSC Communications Corp.*,ⁿ²⁹ the plaintiff made a demand on DSC's board that it rescind a compensation package awarded to its CEO, urging that the package amounted to an impermissible abdication of the directors' duties. After the board rejected the demand, the stockholder, Mr. Grimes, filed a complaint asserting various derivative claims, one of which (the abdication claim) the Delaware Court of Chancery dismissed for failure to state a claim, and others of which it dismissed for failure to make a demand, the necessity for which Mr. Grimes had conceded by making a demand with respect to his abdication claim. The Delaware Supreme Court affirmed the dismissal, noting that Mr. Grimes was not precluded from making another demand with respect to the claims that were not in his first demand and that he had "the right to use the 'tools at hand' [*i.e.*, Delaware General Corporation Law § 220] to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused."ⁿ³⁰ Mr. Grimes made a second demand and, nearly one year later, DSC sent him a brief, one-page letter, referencing but not including the demand investigation committee's report to the board, rejecting the demand.

After receiving the single-page letter rejecting the demand, the stockholder asserted his right under Delaware General Corporation Law § 220 to inspect certain books and records relating to "the formation, investigation and report of the Special Committee and the board's decision to accept the Special Committee's recommendation."ⁿ³¹ DSC produced certain documents in response to the Delaware General Corporation Law § 220 demand, but refused to produce the committee's report or documents accompanying it. DSC also resisted further production on the grounds that Mr. Grimes did not have a proper purpose, that the documents were not necessary to his stated purpose, and were protected by the attorney-client privilege and the work product doctrine.

Noting the Delaware Supreme Court's admonition to stockholders to avail themselves of Delaware General Corporation Law § 220 before filing a derivative lawsuit, the Court of Chancery held that Mr. Grimes' purpose was proper, and rejected the corporation's claims of privilege and work product. The court required the corporation to produce a copy of the report, minutes of all meetings of the special committee, and all board minutes referring to the special committee. The Court specifically rejected, absent a further showing of need, Mr. Grimes' request for interview summaries prepared by counsel and all records of every disbursement made in connection with the investigation.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority Limitations Business & Corporate Law Corporations Shareholders Actions Against Corporations Derivative Actions Procedures Business & Corporate Law Corporations Shareholders Actions Against Corporations Standing Demand Futility Civil Procedure Class Actions Derivative Actions Demand Futility Civil Procedure Class Actions Derivative Actions Demand Requirement

FOOTNOTES:

(n1)Footnote 1. *See Smachlo v. Birkelo*, 576 F. Supp. 1439, 1444-45 (D. Del. 1983) (demand must identify stockholder); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1209 (9th Cir. 1980); *Shlensky v. Dorsey*, 574 F.2d 131, 140-41 (3d Cir. 1978).

(n2)Footnote 2. *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1117 (D. Del.), *aff'd*, 782 F.2d 1026 (3d Cir. 1985); *see also* ALI Principles of Corporate Governance § 7.03(a) (demand must identify the "essential facts" supporting the claims made); *Yaw v. Talley*, CA 12882, 1994 Del. Ch. LEXIS 35, at *21 (Del. Ch. Mar. 2, revised Mar. 7, 1994); *Stoner v. Walsh*, 772 F. Supp. 790, 796 (S.D.N.Y. 1991); *Rubin v. Posner*, 701 F. Supp. 1041 (D. Del. 1988).

(n3)Footnote 3. *See Seibert v. Harper & Rowe Pubs., Inc.*, CA 6639, 1984 Del. Ch. LEXIS 523, at *6-7 (Del. Ch. Dec. 5, 1984).

(n4)Footnote 4. *See Khanna v. McMinn*, 2006 Del Ch. LEXIS at *49; *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1237 n.75 (Del. Ch. 2001), *rev'd on other grounds*, 817 A.2d 149 (Del. 2002); *Leslie v. Telephonics Office Techs., Inc.*, CA 13045, 1993 Del. Ch. LEXIS 272, at *32-33 (Del. Ch. Dec. 30, 1993) (holding that letter enclosing draft complaint did not constitute a demand).

(n5)Footnote 5. *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 731 (Del. 1988).

(n6)Footnote 6. When the subject matter of the demand is sufficiently serious, investigation of the demand generally should be conducted by the board or a committee thereof. The benefits of using a committee include relieving at least some of the directors from the time commitment of the investigation, and excluding persons at whom the charges of wrongdoing have been directed.

(n7)Footnote 7. *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984). However, the Delaware Court of Chancery has ruled that there is reason to doubt the disinterestedness of a director who approves the backdating of options such that he or she is "incapable of impartially considering demand." *Ryan v. Gifford*, 918 A.2d 341, 355-56 (Del. Ch. 2007) ("Backdating options qualifies as one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability exists.'").

(n8)Footnote 8. *Scattered Corp. v. Chicago Stock Exch., Inc.*, 1996 Del. Ch. LEXIS 73, at *11 n.4. (Del. Ch. July 12, 1996), *aff'd*, 701 A.2d 70 (Del. 1997).

(n9)Footnote 9. *Stepak v. Addison*, 20 F.3d 398 (11th Cir. 1994) (refusal of demand wrongful where complaint alleged the committee relied upon the same law firm that represented the alleged wrongdoers in prior criminal proceedings involving same subject).

(n10)Footnote 10. *See Klein v. FPL Group, Inc.*, 2004 U.S. Dist. LEXIS 919 (S.D. Fla. Jan. 20, amended Feb. 5, 2004).

(n11)Footnote 11. Because of the overlap in principles of independence, both with respect to committee membership and outside advisors, it may be possible to use an article regarding SNCs. *See, e.g.*, A. Gilchrist Sparks, III and S. Mark Hurd, *Special Negotiating Committees*, 30 Rev. of Sec. & Comm. Reg. 97 (Apr. 23, 1997).

(n12)Footnote 12. *Rales v. Blasband*, 634 A.2d 927, 935 (Del. 1993) .

(n13)Footnote 13. Jurisdictions following the ABA Model Business Act presume an investigation period of 90 days is reasonable. *See* ABA Model Business Act § 7.42. The ALI Principles of Corporate Governance presumes 60 days is reasonable. *See* ALI Principles of Corporate Governance § 703 (commentary).

(n14)Footnote 14. *Baron v. Siff*, CA 15152, 2004 U.S. Dist. LEXIS 14772 (Del. Ch. Oct. 17, 1997) (internal quotation omitted).

(n15)Footnote 15. *See, e.g., MacCumber v. Austin*, CA 03 C 9405 1997 Del. Ch. LEXIS 152, at *11(N.D. Ill. Aug. 2, 2004) (motion to dismiss, without prejudice, granted where board was not given adequate time to investigate and give a definitive response).

(n16)Footnote 16. The corporation's records will almost always prove to be the most complete source of relevant documents. The committee nonetheless should ascertain if directors and officers, including any of the alleged wrongdoers identified in the demand, have relevant documents in their possession.

(n17)Footnote 17. Documents often will be organized in separate files for use in witness interviews, including documents copied from the files of the particular witness and documents authored by or provided to the witness.

(n18)Footnote 18. *See Brady*, (Tenn. Ct. App. Jan. 11, 2005) (SLC requested interview of plaintiff, who refused to be interviewed, but did interview plaintiff's counsel).

(n19)Footnote 19. The importance of a clear statement from counsel that he or she represents the corporation, and not the individual being interviewed, was recently underscored by the court's decision in *In re Grand Jury Subpoena: Under Seal*, 415 F.3d 333 (4th Cir. 2005) . Counsel should consult and carefully consider applicable ethics rules before conducting interviews.

(n20)Footnote 20. *See § 11.07 above*, for additional discussion regarding minutes, note-taking by committee members, and the benefits of face-to-face committee meetings.

(n21)Footnote 21. The committee should assume that all documents created during the investigation will be discoverable. Although the scope of permissible discovery generally is limited, there can be no certainty regarding the precise scope of discovery that a court may permit and, in some instances, it may not be possible or advisable to assert the attorney-client privilege or other immunity.

(n22)Footnote 22. In the event of an internal resolution, counsel to the stockholder may seek an award of attorneys' fees premised upon the argument that the demand conferred a corporate benefit.

(n23)Footnote 23. *Boeing Co. v. Shrontz*, CA 11273, 1994 Del. Ch. LEXIS 14, at *6 (Del. Ch. Jan. 19, 1994) .

(n24)Footnote 24. *Scattered Corp. v. Chicago Stock Exch.*, 701 A.2d 70, 76 n.24 (Del. 1997) . In *Highland Legacy Ltd. v. Singer*, the Delaware Court of Chancery found that a company's public announcement, in a Form 8-K filing, that it believed a derivative lawsuit had no merit did not render demand futile. C.A. 1566- Highland Legacy Ltd., (Del. Ch. Mar. 17, 2006) .

(n25)Footnote 25. *Boeing*, CA 11273, 1994 Del. Ch. LEXIS 14, at *11 .

(n26)Footnote 26. *Baron*, CA 15152, 1997 Del. Ch. LEXIS 152, at *8-12 .

(n27)Footnote 27. *See Stepak*, 20 F.3d at 407-10 .

(n28)Footnote 28. *Levine v. Smith*, CA 8833, 1987 Del. Ch. LEXIS 524, at *15-17 (Del. Ch Dec. 22, 1987) ; *see*

also *Allison*, 604 F. Supp. at 1120-1121 .

(n29)Footnote 29. *Grimes v. DSC Communs. Corp.*, 724 A.2d 561 (Del. Ch. 1998) .

(n30)Footnote 30. *Grimes v. Donald*, 673 A.2d 1207, 1210 (Del. 1996) .

(n31)Footnote 31. *Grimes v. DSC Communicationss Corp.*, 724 A.2d at 564.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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Corporate Governance: Law and Practice

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CHAPTER 11 SPECIAL COMMITTEES OF THE BOARD *

2-11 Corporate Governance: Law and Practice § 11.10

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§ 11.10 The Special Litigation Committee

[1] Governing Law and Federal Policy

The power of a special committee of independent directors to exercise the full power of the board in making a decision to terminate a derivative lawsuit or permit it to proceed is a reflection of the fact that the board of directors governs the business and affairs of the corporation, including whether claims that belong to the corporation should be pursued. Absent an "overriding" federal policy, whether demand is excused and the ability of a special litigation committee or "SLC" to terminate a derivative action are determined by the law of the state where the corporation is incorporated.ⁿ¹

In *Burks v. Lasker*,ⁿ² for example, the United States Supreme Court concluded that permitting a committee of disinterested directors to move to terminate a derivative action under state law was not inconsistent with the policies underlying the Investment Company Act of 1940. The courts are split on the question of whether federal policy permits a special litigation committee to dismiss claims arising under Section 14(a) of the Securities Exchange Act of 1934 ("1934 Act"), which governs disclosures made in proxy statements.ⁿ³ The competing positions are set forth in *Galef v. Alexander* and *Lewis v. Anderson*. In *Galef*, the plaintiff alleged that the defendants improperly granted stock options and violated Section 14 of the 1934 Act by omitting material information in the proxy statement seeking stockholder approval of the options. A special committee of directors who had been named as defendants, but who had not received any options, recommended dismissal of the action. The Second Circuit held that the purpose of Section 14(a) would "clearly be frustrated" if directors who had been named as defendants for omitting material information in a proxy "were permitted to cause the dismissal of the action simply on the basis of [their] judgment that its pursuit was not in the best interests of the corporation."ⁿ⁴

In *Lewis v. Anderson*,ⁿ⁵ in contrast, the court held that permitting termination of an action asserting Section 14(a) claims would not frustrate federal policy where a special litigation committee comprised of one director-defendant and two non-defendant directors determined the corporation should move to dismiss.ⁿ⁶ Other courts have declined to follow the holding of *Galef* based on a finding that the harm from the wrongdoing was not the "result of" the false or misleading proxy solicitations.ⁿ⁷

[2] Issues Surrounding the Formation of the Special Litigation Committee

The first step upon receiving service of a derivative lawsuit is to examine critically the complaint to determine if it alleges particularized facts establishing that demand (assuming the stockholder did not make one) is excused as futile.ⁿ⁸ If the complaint lacks such allegations, the defendants typically will move to dismiss under Delaware Chancery Court Rule 23.1. Even if counsel determines that a Rule 23.1 motion to dismiss or other motion to dismiss (*e.g.*, based on lack of standing, absence of personal jurisdiction or failure to state a claim) can be brought, depending on the nature of the claims of wrongdoing, it is possible that public relations and other concerns will nonetheless weigh in favor of appointing a special committee in addition to, or in lieu of, a motion to dismiss the derivative lawsuit.

Before appointing a special litigation committee, counsel should consider whether such action might be construed as a concession that demand is excused. Under Delaware law, a concession of demand futility may be found if the plaintiff alleges particularized facts supporting a finding that the board made such a concession.ⁿ⁹

If the particularized allegations of the complaint are sufficient to establish that demand is excused and there is no other potentially case dispositive motion, the corporation and its counsel can either decide to proceed with the litigation or to appoint an SLC with the full authority of the board of directors with respect to the derivative claims.

The choice between proceeding with litigation or appointing an SLC is made more difficult because it typically must be made without full knowledge of all the relevant facts. If demand is excused, in most situations the entire fairness standard will apply and proceeding with litigation typically will result in the considerable expense of a trial. Subject to any applicable retention, the corporation's directors and officers' liability insurance policy often will cover defense costs.ⁿ¹⁰ Although substantial cost savings are possible, the SLC process also may cost hundreds of thousands of dollars, some or all of which may not be covered by the corporation's insurance. Generally, the more complex the issues in the litigation, the more closely the cost of the special committee process will approximate the cost of litigation. Before appointing an SLC, moreover, the corporation's board of directors must be prepared to accept the SLC's determination, including the prospect that the corporation be realigned as the plaintiff.ⁿ¹¹

On the other hand, the SLC process can be valuable not only because of its potential cost savings and as a means of directing the inquiry to an objective investigator and away from the traditionally adversarial derivative plaintiff, but also for independent business reasons, such as minimizing disruption to particularly important management endeavors. Perhaps the most significant consideration in determining whether to appoint an SLC is a thorough assessment of the attitude of the court where the derivative action is pending.

[a] Who Should Be on the Committee?

As with other types of special committees, directors serving on a special litigation committee must be disinterested and independent. The ideal candidate for the position is a director who was not a director at the time of the alleged wrongdoing and, for this reason, a corporation's directors may, if permitted by the charter and bylaws, vote to increase the size of the board of directors and fill the vacancies. The newly-appointed directors are then appointed to the SLC.ⁿ¹²

If there are no directors who were not on the board at the time of the alleged wrongdoing, the SLC should be comprised of those directors who are not named defendants or, in cases where all directors have been named as defendants,ⁿ¹³ with those directors who are not alleged to have divided loyalties with respect to the alleged wrongs. In those instances where a Delaware corporation has a charter provision adopted pursuant to Delaware General Corporation Law § 102(b)(7), and absent a loyalty claim or other exception to the protections offered by Delaware General Corporation Law § 102(b)(7), such directors will not face a reasonable prospect of monetary liability with respect to plaintiff's claims, and may appropriately serve on an SLC.ⁿ¹⁴

As a general matter, the independence and disinterest of the committee members will not be examined until after the SLC has completed its investigation and made a determination regarding the disposition of the derivative suit.ⁿ¹⁵ For

that reason, it is imperative that counsel and the committee completely vet questions of independence--ideally before the SLC is appointed and, in all events, early in the investigation.

A recent decision from the Delaware Court of Chancery, *In re Oracle Corp. Derivative Litigation*,ⁿ¹⁶ suggests that a court may apply more rigorous scrutiny of the independence of SLC committee members than it does in other contexts.ⁿ¹⁷ Specifically, the court suggested that directors would find it "easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (e.g., [an SLC member asked to consider a self-dealing] transaction) that has not yet occurred" than to authorize a lawsuit against them for claims that constitute a criminal offense.

In *Oracle*, shareholder plaintiffs alleged that four directors sold Oracle stock before public announcement of disappointing earnings results. Oracle's board of directors appointed two new directors to an SLC, both tenured and highly-respected professors at Stanford University, neither of whom was "compromised by a fear that support for the prosecution of this suit would endanger his ability to make a nice living."ⁿ¹⁸ Notwithstanding these observations, the court denied the SLC's motion to dismiss, stating that "[h]omo sapiens is not merely *homo economicus*" and finding that the two SLC members lacked the requisite independence from the four Oracle directors based upon a variety of relationships those four directors also had with Stanford University.ⁿ¹⁹ Although the record before the court suggested that the SLC members may have been unaware of some of the facts upon which the court relied, practitioners should note the court's admonition that this board must undertake "a thorough consideration of the facts bearing on the independence of the proposed SLC members from the key objects of the investigation."ⁿ²⁰

[i] Scope of Authority

Although the demand investigation or evaluation committee and the SLC both play important roles within the context of potential and pending derivative litigation, the Delaware Supreme Court has observed that it is "important that these discrete and quite different processes not be confused."ⁿ²¹ As noted above, the demand investigation or evaluation committee generally makes a recommendation to the full board.

The resolutions creating an SLC, unlike those creating a demand investigation or evaluation committee, must delegate to the committee complete board authority with respect to the litigation. A "mere advisory role" is legally deficient because such a limited role "fails to bestow sufficient legitimacy on the Board's decision to warrant deference" by the reviewing court.ⁿ²² In addition to delegating all of the board's authority with respect to a derivative action, the resolutions creating the SLC also should authorize retention of independent legal and other advisors, instruct corporate personnel to cooperate with the committee, address compensation of the committee members and other matters, including indemnification.

[ii] Retaining Counsel

The SLC's determination regarding who to engage as counsel should be governed by the same considerations of independence and familiarity with the process as applies to determining who may serve as a committee member. Under Delaware law, retention of "capable counsel" is deemed an indicia of the SLC's good faith and reasonableness.ⁿ²³ Accordingly, when there is a "vast amount" of documentary or other information to review, an SLC may properly delegate "a large percentage of this work to its counsel and their expert assistants."ⁿ²⁴ An SLC does not, therefore, abdicate its function merely because its counsel devotes substantially more time to the investigation than the committee members do.

Where the committee members exhibit "an understanding of their role, a familiarity with the record, and confidence that the decisions they made were in the best interests of the company," a Delaware court will not "second guess the SLC's decisions regarding the role which counsel played in assisting them in their task."ⁿ²⁵ Some courts, however, have refused to accept an SLC's determination that derivative litigation be dismissed where the committee "relied almost exclusively" on its counsel to conduct the "substantive aspects" of the investigation, thereby shielding the investigation

from scrutiny.ⁿ²⁶

[b] The Investigation Process

[i] *Stay of Discovery during the Investigation*

Upon the formation of an SLC, one of the first steps will be to attempt to secure a stay of any discovery in the derivative action.ⁿ²⁷ Although the first cases in the Delaware Court of Chancery considering the issue held that it was "a foregone conclusion" that a stay of discovery pending an SLC investigation was to be granted,ⁿ²⁸ at least three subsequent decisions from that court have emphasized the trial court's discretion in determining whether a stay of discovery should be ordered and have denied, at least in part, a corporation's motion to stay discovery pending an SLC's investigation.ⁿ²⁹

In the first such case, *Carlton Investments v. TLC Beatrice*,ⁿ³⁰ the corporation did not move for a stay of discovery until eighteen months after the complaint had been filed, and the parties had for months propounded and responded to discovery requests. When the corporation then determined to appoint an SLC and moved for a stay of discovery, the court observed that the grant of a stay was not a matter of right but a matter of discretion implicating the "efficient and fair administration of the machinery of justice."ⁿ³¹ The court also observed that the plaintiff had brought substantial claims and was a large stockholder, thereby obviating the risk that the action was a strike suit, and that plaintiff had a "right to bring its suit and to proceed with its suit."ⁿ³² Exercising its discretion, the court denied the corporation's motion for a stay of discovery. When moving to stay discovery, counsel to the SLC should place before the court information regarding the identity and independence of the SLC members so as to provide some comfort that a stay would be appropriate.ⁿ³³

[ii] *How to Conduct a Special Litigation Committee Investigation*

After retaining counsel and (ideally) securing a stay of discovery in the derivative litigation, the SLC and its counsel will need to identify and collect relevant documents. The process applied to the collection and review of documents by a demand investigation or evaluation committee, described above, also can be applied to the SLC's work. In identifying relevant documents, the SLC and its counsel should consider any discovery requests that the plaintiff may have served with the derivative complaint. In addition to the defendants and the corporation, the SLC also should request copies of relevant documents in the files of third parties, such as outside counsel and other advisors to the corporation.

Following the collection, review and organization of relevant documents, the SLC and its counsel will need to schedule interviews of the named defendants, members of the corporation's management and outside, third-party advisors with knowledge of the facts pertaining to the claims asserted in the derivative complaint. Here, because of the pending lawsuit, it is especially important that the interviewees understand the process and that they are *not* represented by counsel to the SLC. As is true in the investigation of a demand, a written record or summary of each interview generally should be created, one or more committee members should attend and participate in the interviews, and the SLC should consider whether and when it would like to interview the plaintiff or plaintiff's counsel.

As with the interview process, the SLC and its counsel need to be sensitive to the existence of the pending derivative lawsuit when preparing committee minutes, taking notes and drafting the special litigation committee's report regarding the derivative claims.ⁿ³⁴ While no two investigations or reports are identical, most reports will include a description of the claims, a description of the SLC's investigation (including documents reviewed, witnesses interviewed and number of meetings of the committee), detailed factual findings from the SLC's investigation, legal analysis of the claims in light of the committee's factual findings, and a description of the factors considered by the SLC in reaching its determination regarding the disposition of the derivative claims.

[iii] *What Are the Committee's Options?*

The range of options available to the SLC includes a determination that: (1) the corporation should be aligned as the

plaintiff and prosecute some or all of the claims against some or all of the defendants, (2) the plaintiff be permitted to continue to prosecute the litigation, (3) the claims in the litigation be settled, or (4) the lawsuit be dismissed as not in the best interest of the corporation. There is, however, limited case law available regarding what rights and remedies are available to a stockholder plaintiff in the event an SLC makes a determination other than dismissal.

Presumably, if the SLC determines that the corporation should take over all claims against all defendants, the stockholder is not entitled to discovery to challenge that determination.ⁿ³⁵ The SLC also could determine that the corporation should prosecute certain claims against certain of the defendants, but that other claims should be dismissed.ⁿ³⁶ Such a result could occur if the SLC were to determine that there was no reasonable prospect for a recovery against certain of the defendants (because, for example, certain directors were immune from liability based upon a charter provision adopted pursuant to Delaware General Corporation Law § 102(b)(7)), but that claims could be brought against others, including third parties.ⁿ³⁷ The stockholder plaintiff in such a scenario presumably would be allowed limited discovery to challenge the decision to dismiss certain claims or certain defendants.

The SLC also may determine that the derivative action should be settled. Any proposed settlement will require court approval. If an SLC determines to propose a settlement, the stockholder plaintiff will be entitled to limited discovery to evaluate "whether the SLC knew enough about the strengths and weaknesses of the claims to negotiate a fair and reasonable settlement, and whether the settlement reached is in fact fair and reasonable."ⁿ³⁸ In *Carlton*, the court, over plaintiff's objection, approved a multi-million dollar settlement of derivative claims brought against the corporation's CEO, noting that the SLC could "legitimately sacrifice present compensation in the settlement if its good faith, informed judgment indicates to it that that course is best for the corporation."ⁿ³⁹

Another case involving a proposed settlement of derivative litigation, *In re Oracle Securities Litigation*,ⁿ⁴⁰ demonstrates the importance of independent counsel and the scope of the committee's authority. In *Oracle*, a case decided under Delaware law, the committee was formed only after the parties had agreed to a settlement and was represented by the corporation's general counsel. Observing that "in-house attorneys are inevitably subservient to the interests of the defendant directors and officers whom they serve," the court rejected the committee's recommendation that the settlement be approved because the committee had failed to show it acted with the requisite independence and good faith.ⁿ⁴¹

The court instructed that before any further proceedings, the committee would be required to "retain independent counsel having no prior relationship with the corporation or the individual defendants."ⁿ⁴² In response, the corporation formed a two person special litigation committee with full authority over the derivative litigation. The SLC then retained independent counsel and prepared a report detailing the results of its investigation. After reviewing the independence of the committee members and reasons for its conclusion, the court approved the proposed settlement of the derivative claims.ⁿ⁴³

A special litigation committee also is empowered to determine that derivative claims should be dismissed as not in the corporation's best interest. The scope of discovery to which a plaintiff is entitled to challenge that determination, and the scope of judicial review, are discussed below.

[iv] *Discovery after the Special Litigation Committee Completes its Report*

Under Delaware law, following a determination by an SLC that derivative litigation should be dismissed, "[l]imited discovery may be ordered" by the court regarding the independence and good faith of the SLC and its investigation.ⁿ⁴⁴ Discovery "may be undertaken only if first authorized by the court" and does not include discovery into the merits of plaintiff's claims.ⁿ⁴⁵ To the contrary, the limited discovery ordered by the court is directed to an inquiry "into the independence and good faith of the committee and reasonableness of the bases for its conclusion that the derivative action should be dismissed."ⁿ⁴⁶

Although the first opinion in Delaware to consider the scope of discovery suggested it would include the production of all documents reviewed by the committee, subsequent decisions have made it clear that such broad discovery will not be ordered.ⁿ⁴⁷ As a general matter, the SLC will be required to produce the report, minutes of SLC meetings, documents regarding the creation and appointment of the SLC, and retention letters between or among the SLC and its advisors. In other cases, the court also has ordered production of interview summaries, any memoranda prepared by advisors to the committee and drafts of the report. Plaintiff's counsel also will be permitted to depose the members of the committee and may, in certain circumstances, be permitted to depose any nonlegal advisor to the committee. Absent special circumstances, the court will not order a deposition of counsel to the SLC.ⁿ⁴⁸

[c] How Will a Court Review a Special Litigation Committee's Determination?

In those jurisdictions that have considered the issue, courts generally have held that an SLC has the power to cause derivative litigation to be terminated,ⁿ⁴⁹ and many jurisdictions have adopted statutes recognizing that power. The principal approaches to the special litigation process are reviewed below.ⁿ⁵⁰

[i] New York's Auerbach Model

In *Auerbach v. Bennett*,ⁿ⁵¹ the New York Court of Appeals concluded that a special litigation committee could determine to terminate a properly-filed derivative action and held that judicial review of such a decision should be limited to an examination of the SLC's good faith, the independence of its members, and the sufficiency of the committee's investigation. The *Auerbach* court reasoned that courts are "well equipped" to assess the "methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability" but are not well-versed in the "weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems."ⁿ⁵²

Under *Auerbach*, "the substantive aspects of a decision to terminate a shareholder's derivative action ... are beyond judicial inquiry under the business judgment doctrine."ⁿ⁵³ Courts applying the law of Alabama, California, Minnesota and Ohio have adopted the *Auerbach* approach to judicial review of SLC determinations.ⁿ⁵⁴

[ii] Delaware's Zapata Model

Two years after *Auerbach* was decided in New York, the Delaware Supreme Court also held that a special litigation committee could terminate derivative litigation, but reached a different conclusion regarding the scope of judicial review. The two-step scope of review announced in *Zapata Corp. v. Maldonado* ⁿ⁵⁵ applies to cases where demand is excused as futile. In the first step of the analysis, the court examines the "independence and good faith of the committee and the bases supporting its conclusions."ⁿ⁵⁶ The presumptions of the business judgment rule do not apply to the SLC, and the corporation bears the burden of proving the independence and good faith of the committee, as well as the reasonableness of its determination.

Even when the corporation satisfies the burden imposed by the first step of *Zapata*, the court may still apply a second, discretionary step in which it exercises its own "independent business judgment" as to whether dismissal of the action is appropriate. The Delaware Supreme Court concluded that the possibility of this second step was required essentially for the reasons articulated by proponents of the structural bias theory. The court remarked that the committee members were passing judgment on their fellow directors and that "[t]he question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role [in the SLC's decision-making]."ⁿ⁵⁷ The court concluded that the discretionary second step provided a "middle course" between the "business judgment of a board committee" and "unbridled plaintiff stockholder control."ⁿ⁵⁸

Despite the existence of the second step under *Zapata*, at least one Delaware lawyer and former Chief Justice of the Delaware Supreme Court, has suggested it is more properly viewed as a "half-step" in which the trial court analyzes the

reasonableness of the SLC's business judgment to seek dismissal of derivative litigation, rather than imposing its own business judgment.ⁿ⁵⁹ A subsequent decision in the Court of Chancery similarly suggests that *Zapata's* second step is "designed to offer protection for cases in which, while the court could not consciously determine on the first leg of the analysis that there was no want of independence or good faith, it nevertheless 'felt' that the result reached was 'irrational' or 'egregious' or some other such extreme word."ⁿ⁶⁰

In *Kaplan v. Wyatt*, former Chancellor Brown described the "practical complications" of the *Zapata* process, which he described as adding "at least three new hearings to a derivative suit brought by a shareholder in the absence of demand on the board of directors."ⁿ⁶¹ The first hearing involves a motion to stay discovery in which the court may be called upon to resolve competing views regarding the length of the stay. In the event the SLC determines the case should be dismissed, the court again must become involved in the case, after reading the SLC's report, to determine the scope of permissible discovery plaintiff will be allowed to pursue.

At the third and final hearing, following limited discovery, the court considers the motion to dismiss.ⁿ⁶² The court described the motion as:

neither a motion to dismiss under Rule 12(b), nor is it a motion for summary judgment pursuant to Rule 56. This is because it is not addressed to the adequacy of the cause of action alleged in the complaint, on the one hand, nor, on the other, is it addressed to the merits of the issues joined by the pleadings. Rather, the motion is a hybrid one, derived by analogy to a motion to dismiss a derivative suit based upon a voluntary settlement reached between the parties and to a motion brought pursuant to Rule 41(a)(2) whereby a plaintiff unilaterally seeks a voluntary dismissal of the complaint subsequent to the filing of an answer by the defendant.ⁿ⁶³

[iii] Statutory Provisions

As noted above, many states have enacted statutory provisions based upon the ABA Model Business Act or, in one instance, the ALI Principles of Corporate Governance.ⁿ⁶⁴ Those provisions contemplate that directors may properly refuse a demand, thereby foreclosing derivative litigation before it starts.

Other states that continue to recognize the distinction between cases where demand is required and cases where demand is excused as futile, have adopted statutes addressing the powers of an SLC. Some statutes merely recognize the existence of special litigation committees, while others address the standards of judicial review. A statute in Alaska, for example, recognizes that a committee of "disinterested, noninvolved directors" may petition a court to dismiss derivative litigation based upon the committee members' "independent, informed business judgment [that] the action is not in the best interest of the corporation." If the committee members prove their disinterest and independence, and the informed basis on which they exercised their business judgment, the court must then "exercise an independent appraisal of the plaintiff's action" to determine whether dismissal is warranted.ⁿ⁶⁵ A statute in Indiana, in contrast, provides that an SLC's determination that derivative litigation should be dismissed "shall be presumed to be conclusive" unless the plaintiff proves the committee was not disinterested or that its determination was not made after a good faith investigation.ⁿ⁶⁶

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority Discretion Business & Corporate Law Corporations Shareholders Actions Against Corporations Derivative Actions Procedures Civil Procedure Class Actions Derivative Actions General Overview Civil Procedure Class Actions Derivative Actions Demand Requirement

FOOTNOTES:

(n1)Footnote 1. See *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991) .

(n2)Footnote 2. See *Burks v. Lasker*, 441 U.S. 471, 484-85, 99 S. Ct. 1831, 60 L. Ed. 2d 404 (1979) .

(n3)Footnote 3. 15 U.S.C. § 78n(a).

(n4)Footnote 4. *Galef v. Alexander*, 615 F.2d 51, 63 (2d Cir. 1980) . See also *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (N.D. Ill. 1982) ; *In re Westinghouse Sec. Litig.*, 832 F. Supp. 989 (W.D. Pa. 1993) , *aff'd*, 92 F.3d 1175 (3d Cir. 1996) ; *In re Par Pharm., Inc. Derivative Litig.*, 750 F. Supp. 641 (S.D.N.Y. 1990) (claims under 1934 Act § 14(a) and the Racketeer Influenced and Corrupt Organizations Act).

(n5)Footnote 5. *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) , *cert. denied*, 449 U.S. 869, 101 S. Ct. 206, 66 L. Ed. 2d 89 (1980) .

(n6)Footnote 6. *Lewis*, 615 F.2d at 784 . See also *Abramowitz v. Posner*, 672 F.2d 1025, 1031-32 (2d Cir. 1982) (no allegations against members of special litigation committee); *Maldonado v. Flynn*, 671 F.2d 729 (2d Cir. 1982) (same).

(n7)Footnote 7. *Abbey v. Control Data Corp.*, 603 F.2d 724, 732 (8th Cir. 1979) , *cert. denied*, 444 U.S. 1017, 100 S. Ct. 670, 62 L. Ed. 2d 647 (1980) . See also *In re General Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075 (6th Cir.) , *cert. denied*, 444 U.S. 1017, 100 S. Ct. 670, 62 L. Ed. 2d 647 (1980) ; *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981) , *cert. denied*, 454 U.S. 1145, 102 S. Ct. 1006, 71 L. Ed. 2d 297 (1982) .

(n8)Footnote 8. As explained above, demand is excused when there is reason to doubt that a majority of the directors is disinterested and independent with respect to the subject of the lawsuit or if there is reason to doubt that the underlying transaction is subject to the business judgment rule. See § 11.08[2] above.

(n9)Footnote 9. See *Seminaris v. Landa*, 662 A.2d 1350, 1353 (Del. Ch. 1995) .

(n10)Footnote 10. Counsel should be aware, however, of the possibility that a provider of directors and officers' liability insurance will seek a judicial determination that the carrier is entitled to rescind the policy due to wrongdoing in the application process.

(n11)Footnote 11. Even in the event the SLC determines the action should be dismissed, moreover, if the court rejects that determination the plaintiff will have the SLC's report as a roadmap for further discovery. See *Teachers' Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654, 664 (Del. Ch. 2006) (noting that access to SLC report provided an opportunity to "craft a high-quality complaint").

(n12)Footnote 12. See *Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, CA 13950, 1997 Del. Ch. LEXIS 86, at *4 (Del. Ch. May 30, 1997) . In many jurisdictions other than Delaware, the mere fact that a director was on the board at the time of the alleged wrongdoing and has been named as a defendant is sufficient to preclude that director from serving on an SLC.

(n13)Footnote 13. That a person approved a transaction and has been named as a defendant typically does not disqualify that person from service on an SLC. See *Kindt v. Lund*, CA 17751- NC, slip op. at 5 (Del. Ch. May 30, 2003); *Katell v. Morgan Stanley Group, Inc.*, CA 12343, 1995 Del. Ch. LEXIS 76, at *19-21 (Del. Ch. June 15, 1995) ; *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785 (Del. 1981) .

(n14)Footnote 14. See § 5.02 above for discussion of exculpation under § 102(b)(7) of the Delaware General Corporation Law.

(n15)Footnote 15. *Biondi v. Scrushy*, 820 A.2d 1148 (Del. Ch. 2003) .

(n16)Footnote 16. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) , summary judgment granted, 867 A.2d 904 (Del. Ch. 2004) , *aff'd*, 2005 Del. LEXIS 150 (Apr. 14, 2005) .

(n17)Footnote 17. *But see Beam v. Stewart*, 845 A.2d 1040, 1056 (Del. 2004) (citing the decision in *Oracle* in context of demand analysis, but not deciding whether independence for purposes of demand differed from independence in the SLC context).

(n18)Footnote 18. *Oracle*, 824 A.2d at 930 .

(n19)Footnote 19. *Oracle*, 824 A.2d at 938 , 942-47.

(n20)Footnote 20. *See Oracle*, 824 A.2d at 943 .

(n21)Footnote 21. *Grimes v. Donald*, 673 A.2d 1207, 1216 n.13 (Del. 1996) .

(n22)Footnote 22. *In re Par Pharm., Inc. Derivative Litig.*, 750 Supp. 641, 647 (S.D.N.Y. 1990). *See also Biondi*, 820 A.2d 1148 (criticizing board resolutions creating an SLC that reserved for the company the ability to seek dismissal of the litigation).

(n23)Footnote 23. *Kaplan v. Wyatt*, 499 A.2d 1184, 1191 (Del. 1985) . The same court also took a critical view of the presence of the corporation's in-house counsel during interviews conducted by the SLC. *See Kaplan*, 499 A.2d at 1190 .

(n24)Footnote 24. *Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, CA 13950, 1997 Del. Ch. LEXIS 86, at *32 (Del. Ch. May 30, 1997) .

(n25)Footnote 25. *Carlton Investments*, CA 13950, 1997 Del. Ch. LEXIS 86, at *47 .

(n26)Footnote 26. *See Peller v. Southern Co.*, 707 F. Supp. 525, 529 (N.D. Ga. 1988) , *aff'd*, 911 F.2d 1532 (11th Cir. 1990) ; *see also Johnson v. Hui*, 811 F. Supp. 479, 488-89 (N.D. Cal. 1991) .

(n27)Footnote 27. The appropriate length of a stay may vary with the circumstances. One court has observed that "courts generally allow SLCs between six and ten months to investigate and report on pending derivative actions." Silverstein, (D. Minn. Feb. 25, 2005) .

(n28)Footnote 28. *Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. Ch. 1984) , *aff'd*, 499 A.2d 1184 (Del. 1985) ; *see also Peller v. Southern Co.*, 707 F. Supp. 525, 529 (N.D. Ga. 1988) , *aff'd*, 911 F.2d 1532 (11th Cir. 1990) .

(n29)Footnote 29. Courts generally will not stay an action under § 220 to compel production of books and records, notwithstanding an ongoing SLC investigation, because rights under § 220 exist independently of derivative litigation and because of the policy encouraging the use of § 220 as an information gathering tool. *See, e.g., Kaufman v. Computer Assocs. Int'l, Inc.*, C.A. No. 699-N, 2005 Del. Ch. LEXIS 192, at *11-12 (Del. Ch. Dec. 21, 2005) ; *Romero v. Career Educ. Corp.*, C.A. No. 793-N, 2005 Del. Ch. LEXIS 112, at *8-9 (Del. Ch. July 19, 2005) .

(n30)Footnote 30. *Carlton Invs. v. TLC Beatrice Int'l Holdings*, CA 13950, slip op. at 26 (Del. Ch. June 6, 1996).

(n31)Footnote 31. *Carlton Invs.*, CA 13950, slip op. at 26.

(n32)Footnote 32. *Carlton Invs.*, CA 13950, slip op. at 29. *See also Milstein v. Milstein*, CA 18180 (Del. Ch. Oct. 13, 2000).

(n33)Footnote 33. *Biondi*, 820 A.2d 1148 (court declined to grant a stay where undisputed facts demonstrated that a subsequent decision to dismiss could not be respected by the court).

(n34)Footnote 34. Although a written report is almost always advisable, "there is no authority that suggests that Delaware law requires a formal 'report' as a matter of law." *Gatz v. Ponsoldt*, CA 174- N, slip op. at 13 (Del. Ch. Nov. 5, 2004).

(n35)Footnote 35. Plaintiff's counsel may be entitled to an award of attorneys' fees, although the determination of the amount (unless agreed to by the corporation) might reasonably be deferred until after the litigation is finally concluded. It should be noted that once the corporation assumes control of the litigation, Rule 23.1 is no longer applicable and the action could be settled without court approval.

(n36)Footnote 36. *See, e.g., Teachers' Ret. Sys. Of La. v. Aidinoff*, 900 A.2d 654, 661 (Del. Ch. 2006) (finding that the defendants who were not dismissed could not challenge the plaintiffs' complaint for failure to plead demand excusal).

(n37)Footnote 37. The effect of pending claims against third parties when a corporation appoints an SLC has not been developed in the case law, resulting in a number of open questions. For example, issues regarding whether a stay of discovery would apply to third parties who were unwilling to cooperate with the SLC process have not been addressed by the courts.

(n38)Footnote 38. *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, CA 13950, 1997 Del. Ch. LEXIS 4, at *3 (Del. Ch. Jan. 28, 1997) .

(n39)Footnote 39. *Carlton Invs v. TLC Beatrice Int'l Holdings, Inc.*, CA 13950, 1997 Del. Ch. LEXIS 86, at *45 (Del. Ch. May 30, 1997) .

(n40)Footnote 40. *In re Oracle Sec. Litig.*, 829 F. Supp. 1176 (N.D. Cal. 1993) .

(n41)Footnote 41. *Oracle*, 829 F. Supp. at 1188-90.

(n42)Footnote 42. *Oracle*, 829 F. Supp. at 1190.

(n43)Footnote 43. *In re Oracle Sec. Litig.*, 852 F. Supp. 1437, 1444 (N.D. Cal. 1994) .

(n44)Footnote 44. *See Zapata*, 430 A.2d at 788 .

(n45)Footnote 45. *Kaplan*, 484 A.2d at 507 .

(n46)Footnote 46. *Kaplan v. Wyatt*, CA 6361, 1984 Del. Ch. LEXIS 417, at *4 (Del. Ch. Jan. 18, 1984) .

(n47)Footnote 47. *See Kindt v. Lund*, CA 17751, letter op. (Del. Ch. Dec. 14, 2001, clarified Jan. 10, 2002).

(n48)Footnote 48. Among the special circumstances that may result in broader discovery, including a deposition of counsel to the SLC, is the existence of a one-member committee. *See Sutherland*, (Del. Ch. July 2, 2007) (ordering production of all documents reviewed and relied upon and deposition of counsel).

(n49)Footnote 49. *See, e.g., Roberts v. Alabama Power Co.*, 404 So. 2d 629, 632, 636 (Ala. 1981) ; *Gaines v. Haughton*, 645 F.2d 761, 770-72 (9th Cir. 1981) , certif. denied, 454 U.S. 1145, 102 S. Ct. 1006, 71 L. Ed. 2d 297 (1982) ; *Bach v. National W. Life Ins. Co.*, 810 F.2d 509, 511-12 (5th Cir. 1987) (applying Colorado law); *Joy v. North*, 692 F.2d 880, 887-93 (2d Cir. 1982) , cert. denied, 460 U.S. 1051, 103 S. Ct. 1498, 75 L. Ed. 2d 930 (1983) ; *Peller v. Southern Co.*, 911 F.2d 1532, 1536 (11th Cir. 1990) (applying Georgia law); *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1498-1500 (D. Md. 1985) ; *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 57 (Mass. 1990) ; *Genzer v. Cunningham*, 498 F. Supp. 682, 686-87 (E.D. Mich. 1980) ; *Skoglund v. Brady*, 541 N.W.2d 17, 20-21 (Minn. Ct. App. 1995) ; *Alford v. Shaw*, 320 N.C. 465, 358 S.E.2d 323, 325-28 (N.C. 1987) , subsequent history, 327 N.C. 526, 398 S.E.2d 445 (N.C. 1990) ; *Miller v. Bargaheiser*, 70 Ohio App. 3d 702, 591 N.E.2d 1339, 1341-43 (Ohio Ct. App. 1990)

; *Cuker v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042, 1048-49 (Pa. 1997); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 798-800 (E.D. Va. 1982).

(n50)Footnote 50. Under Iowa law, interested directors of an Iowa corporation may never confer the power to terminate derivative litigation upon an SLC consisting of less than a majority of the corporation's directors. *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983).

(n51)Footnote 51. *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (N.Y. 1979).

(n52)Footnote 52. *Auerbach*, 393 N.E.2d at 1002.

(n53)Footnote 53. *Auerbach*, 393 N.E.2d at 996.

(n54)Footnote 54. See *Stallworth v. AmSouth Bank*, 709 So. 2d 458, 465 (Ala. 1997); *Gaines v. Haughton*, 645 F.2d 761, 770-72 (9th Cir. 1981) (predicting California law); *Skoglund v. Brady*, 541 N.W.2d 17, 20 (Minn. Ct. App. 1995); *Miller v. Bargaheiser*, 70 Ohio App. 3d 702, 591 N.E.2d 1339, 1343 (Ohio Ct. App. 1990).

(n55)Footnote 55. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

(n56)Footnote 56. *Zapata*, 430 A.2d at 788.

(n57)Footnote 57. *Zapata*, 430 A.2d at 787.

(n58)Footnote 58. *Zapata*, 430 A.2d at 788.

(n59)Footnote 59. See E. Norman Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions--An Analytical Framework for Litigation Strategy and Counseling Directors*, 37 Bus. Law. 1247, 1268 (1982).

(n60)Footnote 60. *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, CA 13950, 1997 Del. Ch. LEXIS 86, at *7 (Del. Ch. May 30, 1997).

(n61)Footnote 61. *Kaplan*, 484 A.2d at 509.

(n62)Footnote 62. *Kaplan*, 484 A.2d at 510-12.

(n63)Footnote 63. *Kaplan*, 484 A.2d at 506-07.

(n64)Footnote 64. *Cuker v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042 (Pa. 1997) (adopting ALI Principles of Corporate Governance by court decision).

(n65)Footnote 65. *Alaska Stat.* § 10.06.435.

(n66)Footnote 66. *Ind. Code Ann.* § 23-1-32-4.

* Portions of this Chapter have been adapted from materials used by the authors in other publications, including *Special Committees of Independent Directors*, 79 C.P.S. (Bureau of National Affairs).



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Corporate Governance: Law and Practice

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice 12.syn

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§ 12.syn Synopsis to Chapter 12: GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

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§ 12.02 Standards for Reviewing Actions by the Target's Directors

§ 12.03 Business Judgment Rule: Special Considerations

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[d] Poison Pills

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FOOTNOTES:

(n1)Footnote *.

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.01

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§ 12.01 Introduction to Governance in the Corporate Control Context

This chapter will discuss the legal standards to which boards of directors are subject in the context of corporate control transactions, and will also discuss board best practices in connection with such transactions. Corporate control transactions are transactions in which someone acquires control of a public company. Corporate control transactions, by definition, represent defining moments for an enterprise, and demand extensive board involvement and input. In light of their importance and the danger of premature disclosure, such transactions tend to move at a fast pace. Further, the public scrutiny and heightened litigation risk to which transactions are subject make advance preparation--to ensure that the board can meet its exacting duties--all the more important for boards and their legal advisers.

The applicable standards and practices will vary depending on the facts and circumstances and the particular form that the control transaction takes. The transaction may take the form of a cash tender offer or cash merger where the target's public holders are bought out and no longer share in the future value of the enterprise, it may take the form of an exchange offer or stock-for-stock merger where target shareholders become shareholders of the combined enterprise, or it may be some combination of these forms. The target may have a controlling stockholder or it may not. In a stock-for-stock transaction, the acquiring entity may have one larger stockholder or it may have a fluid aggregation of unaffiliated stockholders of which the former target stockholders become part. The applicable standards will be affected significantly if the acquiring party is an insider of the target rather than an unaffiliated third party.

In addition to setting out the applicable standards and practices that would apply in the case of an actual change of control transaction, this chapter also discusses how a board might prudently prepare itself long before it is faced with responding to a change of control proposal.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities



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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.02

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§ 12.02 Standards for Reviewing Actions by the Target's Directors

Publicly traded corporations in the United States are incorporated under state law. State corporation law--not federal securities law--governs the duties of directors in responding to a takeover proposal. The United States Supreme Court has made clear that, while claims of nondisclosure by a bidder or a target can be brought under the federal securities laws, claims that directors have breached their fiduciary duties in connection with a tender offer or merger must be based on state law.ⁿ¹

More publicly held companies in the United States are incorporated in Delaware than in any other state.ⁿ² Accordingly, the case law in Delaware relating to directors' duties in responding to acquisition proposals is far more extensive than that in any other state. For these reasons, this discussion of directors' duties in the corporate control context focuses on Delaware case law. Directors of, and lawyers for, companies incorporated in other states should be aware that the standards in those states may differ from those in Delaware.

If state standards are not uniform, it is also true that the standards Delaware courts apply to test directors' responses to takeovers have evolved over time and differ in their formulation depending on the circumstances. The principal standards include:

- *The general business judgment rule.* Under the general business judgment rule, there is a presumption that, in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company.ⁿ³ Under this test, courts will respect the decisions of directors unless they are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.ⁿ⁴

- *The enhanced business judgment rule: the Unocal test.* In reviewing a board's decision to take defensive action against a threatened acquisition of control, Delaware courts apply an enhanced business judgment rule, requiring the directors to show the existence of a threat to corporate policies and that the action they have taken was reasonable in relation to the threat posed. This test is sometimes referred to as the *Unocal* test, since it was first articulated by the Delaware Supreme Court in a case involving a defense by Unocal Corporation against a takeover bid by an affiliate of T. Boone Pickens, Jr.ⁿ⁵

- *Seeking the best price reasonably available: the Revlon test.* If the directors authorize the sale of control of the company, they have a duty to seek the best price reasonably available. This duty is often referred to as a *Revlon* duty, since it was described by the Delaware Supreme Court in a case involving Revlon's reaction to a takeover bid.ⁿ⁶

- *Shareholders should not be disenfranchised: the Blasius test.* An action taken without shareholder approval, with the sole or primary purpose of thwarting a shareholder vote or disenfranchising shareholders, will be upheld only if the directors can show a compelling justification for the action. This is sometimes called the *Blasius* test, after a leading case articulating it.ⁿ⁷

- *The entire fairness test.* If the directors have economic interests that are in material conflict with those of the shareholders, the general business judgment rule may not be applicable, and the directors may have to demonstrate that the transaction is entirely fair to the corporation and the shareholders.ⁿ⁸ This test is sometimes referred to as the "entire fairness" test. The entire fairness test may also apply if the directors are not able to show the other predicates of the business judgment rule--for example, if the directors have disregarded a manifest problem to a degree calling into question whether they were acting in good faith. In some circumstances--for example, if the transaction is made subject to the approval of holders of a majority of the publicly held shares, or a committee of disinterested directors has vigorously represented the interests of the public shareholders--the burden shifts to the plaintiff to show why the transaction is not entirely fair.

The array of different tests that courts apply to review the conduct of directors of target companies appears to be bewildering. If directors' conduct is challenged in the courts, litigators can spend many hours and produce reams of briefs arguing over which test is applicable in a given case. From a counseling point of view, however, we can articulate the following general principles (not expressly articulated in the cases):

- *Judges are reluctant to impose their business judgment on corporations.* Courts do not generally like to substitute their business judgment for that of the directors. Courts know that state legislatures have entrusted the management of corporate affairs to directors, not to the courts. Courts also know that shareholders have elected the directors, not the judge, to supervise the management of the company. In reviewing directors' responses to a takeover, it is comforting to a court if public shareholders have the power to vote the incumbent board out of office if the board thwarts shareholder wishes in resisting a takeover.

- *Good process is important.* The fairness of a corporate transaction has two components: substantive fairness ("fair price") and procedural fairness ("fair dealing").ⁿ⁹ Courts do not generally like to decide whether a corporate transaction is substantively fair--for instance, whether the terms of a merger are fair. The more the defendants can show procedural fairness--for example, careful study by disinterested directors with access to relevant material information and with good and knowledgeable advisers--the less likely it is that a court will overturn the directors' determination as to the economic fairness of a transaction.

■ *Conflicts of interest tend to lead to greater judicial review.* If directors have material economic interests in a transaction different from those of the public shareholders, courts are more likely to review the transaction carefully. Good process--for example, effective use of a committee of outside directors--is important in satisfying this heightened judicial review.

■ *Shareholder disenfranchisement is disfavored.* A corollary of the importance of the shareholder vote as a safeguard against unreasonable defensive actions is that courts are more likely to scrutinize a defensive action that tends to disenfranchise the shareholders of the target company.¹⁰

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Directors & Officers Scope of Authority

FOOTNOTES:

(n1)Footnote 1. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 105 S. Ct. 2458, 86 L. Ed. 2d 1 (1985) . See also *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977) .

(n2)Footnote 2. See State of Delaware, Why Choose Delaware as Your Corporate Home?, at <http://www.corp.delaware.gov/default/shtml> (last updated March 3, 2009) (noting that "more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500" are incorporated in Delaware; see also Black, Lewis S., Jr., *Why Corporations Choose Delaware* 1 (CSC 2007). The importance of Delaware as a state of incorporation is based on many factors, including low franchise taxes, a good corporation statute, an excellent bar, a well-trained and professional judiciary accustomed to corporate litigation, and familiarity.

(n3)Footnote 3. *In re the Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746-47 (Del. Ch. 2005) , aff'd, 906 A.2d 27 (Del. 2006) .

(n4)Footnote 4. *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) . The general business judgment rule is discussed in detail in Chapter 4 above.

(n5)Footnote 5. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) .

(n6)Footnote 6. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) .

(n7)Footnote 7. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) .

(n8)Footnote 8. See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) .

(n9)Footnote 9. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) .

(n10)Footnote 10. In an unusual article published in 2001, former Delaware Chancellor William T. Allen and two then-sitting Vice Chancellors, Jack Jacobs and Leo Strine (Jacobs has since been elevated to the Delaware Supreme Court), suggested that the standards of review applied in the Delaware cases needed to be changed. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr. *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 *Bus. Law.* 1287, 1310-11 (2001). First, the authors argued that the *Unocal* test should be uncoupled from the business judgment and entire fairness standards. If directors take actions that impede stockholders' ability to sell their shares or to elect a new board, the authors suggested a unitary inquiry into whether such defensive measures were reasonable in light of the circumstances, without a need to examine whether an inadequately informed board acted "fairly," for "it seems highly unlikely that the board could show that those measures [that failed the *Unocal* standard] were, nonetheless, 'fair.' " Nor would the authors require directors shown to have breached their duty of care to demonstrate entire fairness. *Id.* at 1304-05. Further, the authors saw no need for a separate *Blasius* test, which

overlaps the *Unocal* test. Instead, the authors submitted that board actions that threaten the shareholders' franchise should be evaluated under the *Unocal* standard, "trusting the courts to recognize that there are fundamental limitations on the power of corporate directors to impair the ability of the governed to remove them at the polls." *Id. at 1320* (emphasis omitted).

Also, apart from the requirement that, in a sale of control, directors' actions must be evaluated solely with reference to their duty to obtain the best price reasonably available, the authors believed that the *Revlon* and *Unocal* standards are similar--particularly since Delaware courts give directors discretion to seek the best price by a variety of methods, including single-bidder negotiations supplemented with a market check. *Id. at 1321*. Further, the authors submitted that the directors should have to prove entire fairness only if the transaction involves self-dealing. The business judgment standard should apply to a going private merger if the merger (1) was expressly conditioned on approval by an informed and uncoerced majority of the minority, or (2) was approved as fair by an effective and uncoerced special committee of independent directors. *Id. at 1317*. Finally, the authors would eliminate the rule that a fully informed approval by the disinterested shareholders does not insulate directors from claims if the transaction involved a waste of corporate assets. *Id. at 1317-18*.



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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.03

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§ 12.03 Business Judgment Rule: Special Considerations

As the Delaware Supreme Court has indicated, a director's decision will not be respected by the courts if the director is interested in the transaction, lacks independence relative to the decision, or does not act in good faith.ⁿ¹ The "interest" and "independence" components of the duty of loyalty frequently create confusion, because similar factual circumstances may implicate both interest and independence, one but not the other, or neither.ⁿ²

The Delaware Supreme Court first explained the meaning of "interest" and "independence" under Delaware law in *Aronson v. Lewis*.ⁿ³ In that case, the court stated that, with respect to "interest," the business judgment rule requires that "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."ⁿ⁴ This definition was further refined in *Rales v. Blasband*,ⁿ⁵ where the Delaware Supreme Court explained that "directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders."ⁿ⁶

In *Cede & Co. v. Technicolor, Inc.*, the Delaware Supreme Court rejected the contention that "any" director self-interest, standing alone and without evidence of self-dealing, is sufficient to rebut the presumption of loyalty under the business judgment rule.ⁿ⁷ Rather, such self-interest must be material to the director. In *Cinerama, Inc. v. Technicolor, Inc.*,ⁿ⁸ the Delaware Supreme Court adopted a subjective "actual person" standard for determining materiality, which requires the court to determine whether "this director in fact was or would likely be affected" by the self-interest in question.ⁿ⁹ The court further explained that the "actual person" standard requires an independent judicial determination of whether the director in question had "some special characteristic that [made] him ... especially susceptible to or immune to opportunities for self-enrichment" or whether there is "evidence that [the director] in fact behaved differently in this instance than one would expect a reasonable person in the same or similar circumstances to act."ⁿ¹⁰

Thus, a disabling director "interest" may exist in two instances. First, it exists where a director personally receives a benefit (or suffers a detriment) as a result of the challenged transaction that is not generally shared by the shareholders of the corporation and that is of such subjective material significance to that particular director that it is reasonable to question whether the director objectively considered the advisability of the challenged transaction to the corporation and its shareholders.ⁿ¹¹ Second, a director is "interested" if the director stands on both sides of the challenged transaction. In this latter situation, a showing of materiality is not required.ⁿ¹²

On the separate question of "independence," the Delaware Supreme Court stated in *Aronson* that "independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."ⁿ¹³ The court explained that such extraneous considerations or influences may exist when the challenged director is controlled by another, and that to raise a question concerning the independence of a particular board member, a plaintiff asserting the "control of one or more directors must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.'" The shorthand shibboleth of 'dominated and controlled directors' is insufficient."ⁿ¹⁴ One way to allege successfully that an individual director is under the control of another is by pleading "such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person."ⁿ¹⁵

Thus, as Chancellor Chandler stated in summarizing Delaware law on the question of independence, "independence" does not involve a question of whether the challenged director derives a benefit from the transaction that is not generally shared with the shareholders of the corporation. Rather, the inquiry must focus on whether the director's decision resulted from that director's being controlled by another. The Chancellor explained that

[a] director can be controlled by another if in fact he is dominated by that other party, whether through close personal or familial relationship or through force of will. A director can also be controlled by another if the challenged director is "beholden" to the allegedly controlling entity, which is the case where the allegedly controlling entity "has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively."ⁿ¹⁶

In assessing director independence, Delaware courts apply the same subjective "actual person" standard that they apply in cases involving director self-interest, in order to determine "whether a 'given' director was likely to be affected in the same or similar circumstances."ⁿ¹⁷ Thus, both in the case of "interest" and in the case of "independence," the key issue is not simply whether a particular director receives a benefit from a challenged transaction not shared with the shareholders of the corporation, or solely whether another person or entity has the ability to take some benefit away from a particular director, but "whether the possibility of gaining some benefit or the fear of losing a benefit is likely to be of such importance to that director that it is reasonable for the court to question whether valid business judgment or selfish considerations animated that director's vote on the challenged transaction."ⁿ¹⁸

An example of the approach of the Delaware courts can be seen in the decision of the Delaware Court of Chancery in *Kohls v. Duthie*,ⁿ¹⁹ where the court declined to enjoin a management buy-out transaction in which a small publicly held utility company was to be acquired by a financial sponsor. In *Kohls*, the CEO of the target owned 35 percent of the company's stock and was contributing his shares into the offer in exchange for equity in the purchaser. The transaction was negotiated by a special committee advised by independent legal and financial advisers, and was subject to a condition that 85 percent of the shares owned by persons other than the CEO be tendered. The plaintiffs alleged that the entire fairness standard was applicable to the transaction in question, because one member of the two-member special committee that negotiated the transaction lacked independence as a result of his friendship with the CEO and because the company had invested \$5 million in a fund of which the committee member was COO and CFO. In addition, the

plaintiffs alleged that the other committee member was a defendant in a derivative suit alleging as a usurpation of a corporate opportunity the purchase by the CEO--rather than by the company--of a large block of stock at a low price, and arguing that the committee's work was therefore tainted by his self-interest in seeing an end to the litigation.ⁿ²⁰

Vice Chancellor Lamb rejected these arguments, stating that "the law is clear that 'evidence of personal and/or business relationships does not raise an inference of self-interest.'" ⁿ²¹ The court found nothing about the first committee member's relationship with the CEO to suggest that he could not exercise independent judgment, as required by his fiduciary duties, when acting as a member of the special committee. Nor was the company's \$5 million investment in a \$1.3 billion fund of which the director was an officer so material as to make the committee member dependent upon or subject to the domination of the CEO of the company.ⁿ²² The court also rejected the plaintiffs' argument that the other committee member's status as a defendant in the derivative litigation was such a material interest in the proposed transaction as to taint the special committee by his involvement. This conclusion was based on the overall weakness of the derivative suit as well as the fact that the only remedy available to the plaintiffs on the derivative claim was the cancellation of the shares acquired by the CEO, rather than any possibility of a money judgment against the director defendant. For these reasons, the Vice Chancellor concluded that the functioning of the committee should be reviewed under the business judgment rule rather than the more rigorous entire fairness standard.ⁿ²³

The Delaware Chancery Court in *In re Oracle Corp. Derivative Litig.* ⁿ²⁴ looked at the issue of independence in a different context, but its decision may nevertheless suggest a shift in how Delaware courts look at outside personal and business relationships in assessing the independence of directors. This decision arose out of a shareholder derivative litigation, asserting claims on behalf of the corporation, claiming that Oracle's CEO and several other Oracle directors had breached their duties to the company by engaging in insider trading--selling Oracle shares before the announcement of an earnings shortfall. Often, in response to such an action, a corporation's board of directors appoints a special litigation committee ("SLC") made up of independent directors to consider whether the action should proceed. If the SLC is independent and decides after careful review not to proceed with the litigation, the SLC's motion to terminate the action is likely to be granted.

Oracle set up an SLC made up of two directors, both of whom had joined the board well after the earnings announcement. The SLC's counsel interviewed 70 witnesses, with SLC members participating in several of the key interviews. The SLC produced an 1,100-page report, concluding that the defendants did not have any material nonpublic information about the earnings shortfall and that Oracle should not pursue the claims against the defendants. The SLC moved to terminate the derivative litigation.

The court denied the motion to dismiss, finding that the SLC had failed to demonstrate that no material factual question existed regarding its independence. The court noted that: both SLC members were professors at Stanford University; one of the defendants was also a professor at Stanford and had taught one of the SLC members; another defendant was a big donor to Stanford (one of his gifts was \$50,000, made after an SLC member gave a speech at the defendant's request); and Oracle's CEO himself was reported to be considering giving \$170 million to Stanford.ⁿ²⁵ The court reached its conclusion even though the two SLC members had tenure at Stanford and so were not vulnerable to being fired, had no fund-raising responsibilities at Stanford, and were not shown to be controlled by any of the defendants.

In a subsequent decision, the Delaware Supreme Court went out of its way to limit the reach of *Oracle*. In *Beam v. Stewart*,ⁿ²⁶ Delaware Chief Justice Veasey noted that mere allegations that directors are friends or move in the same business and social circles is not enough to negate independence for purposes of excusing the requirement for demand on directors in a shareholder derivative action. He contrasted the concept of independence in the context of a special litigation case such as *Oracle*, noting that an SLC has the burden of establishing its own independence. Similarly, in a case arising from JP Morgan Chase's acquisition of Bank One, Delaware Vice Chancellor Lamb rejected a claim that a majority of JP Morgan Chase's directors lacked independence as a result of business, charitable or family relationships with JP Morgan Chase or its CEO.ⁿ²⁷ He found that the relationships alleged failed to demonstrate that the directors were beholden to the CEO.

Finally, on the issues of interest and independence, to rebut successfully the business judgment rule presumption that the board acted loyally, a plaintiff must show that "a majority of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director."²⁸ If a single director, or a minority of the directors, has a conflicting interest or lacks independence, the decision of the board as a whole still may be entitled to the protection of the general business judgment rule, if the material facts as to such conflicting interests or lack of independence are disclosed or are known to the board of directors, and the board in good faith authorizes the transaction by the affirmative vote of a majority of the disinterested directors.²⁹ However, the business judgment rule would not be applicable if the interested or dependent directors controlled or dominated the board and the decision-making by the disinterested directors.³⁰ To increase the likelihood that the decision of the directors of a target company will be entitled to the protection of the business judgment rule, it is generally desirable, at the outset of a board meeting considering a possible business combination transaction, to make known to the board any interests that directors have in the bidder(s) for the company or any controlling influences by such bidder(s).

In *Malpiede v. Townson*,³¹ the Delaware Supreme Court followed this approach in affirming the dismissal for failure to state a claim of an action arising out of a sale of Frederick's of Hollywood. In *Malpiede*, the Frederick's board signed a merger agreement, subject to shareholder approval, accepting a two-step tender offer of \$7.75 per share from Knightsbridge Capital Corp., thereby effectively ending the bidding process, and subsequently rejected an offer of \$9 per share from a competing bidder, Veritas Capital Fund. Frederick's shareholders brought suit alleging that the directors had breached their duty of loyalty.

Only one of the directors appeared to have a conflict of interest--the CEO, who was to receive \$0.05 for each underwater option, a severance payment of \$750,000 on consummation of the merger, and a payment of \$250,000 on the date of the merger in sixteen quarterly payments of \$100,000 under a non-compete and consulting agreement--and the plaintiffs did not allege that the apparently conflicted director dominated the other directors. The plaintiffs also alleged that the directors were concerned that if they decided to enter into the merger agreement with Veritas, Knightsbridge would sue them, and therefore, the directors' individual interests in avoiding personal liability to Knightsbridge influenced their decision to approve the merger. The Supreme Court of Delaware disagreed, reasoning that "[e]xcept in egregious cases, the threat of personal liability for approving a merger transaction does not in itself provide a sufficient basis to question the disinterestedness of directors, because the risk of litigation is present whenever a board decides to sell the company."³² Moreover, there was evidence that Veritas agreed to indemnify the directors in the event Knightsbridge sued them. Therefore, the court concluded that the merger with Knightsbridge was approved by a majority of disinterested directors and that "the facts alleged in the complaint do not state a cognizable claim that the directors acted in their own personal interests rather than in the best interests of the stockholders when they approved the Knightsbridge merger."³³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesFiduciary ResponsibilitiesBusiness & Corporate LawCorporationsDirectors & OfficersScope of Authority

FOOTNOTES:

(n1)Footnote 1. *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) . The Delaware Supreme Court has held that the duty of good faith is separate from - though intertwined with - the duties of care and loyalty. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006) . The court acknowledged, however, that the duty of good faith "is not a well-developed area of [Delaware's] corporate fiduciary law" *In re The Walt Disney Co.*, 906 A.2d at 64 . In *Orman v. Cullman*, Chancellor Chandler had suggested that the duty to act in good faith was not a separate fiduciary duty of corporate directors, but merely a subset of the duty of loyalty (*quoting Emerald Partners v. Berlin*, C. A. No. 9700, 2001 Del. Ch. LEXIS 20, at *86 n.63 (Del. Ch. Feb. 7, 2001)) , vacated and remanded on other grounds by 787 A.2d 85

(*Del. 2001*) ("[a]lthough corporate directors are unquestionably obligated to act in good faith, doctrinally such obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or 'subsidiary requirement' that is subsumed within the duty of loyalty, as distinguished from being a complementary distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care"). In *Stone v. Ritter*, 911 A.2d 362, 370 (*Del. 2006*), the Delaware Supreme Court confirmed this view, holding that the requirement to act in good faith is a "subsidiary element" of the duty of loyalty, not "an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."

(n2)Footnote 2. See *Orman v. Cullman*, 794 A.2d 5 (*Del. Ch. 2002*), for a good summary by Delaware Chancellor Chandler of "established Delaware law" on director self-interest and lack of independence.

(n3)Footnote 3. *Aronson v. Lewis*, 473 A.2d 805 (*Del. 1984*).

(n4)Footnote 4. *Aronson*, 473 A.2d at 812. See also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (*Del. 1993*), where the Delaware Supreme Court explained that "[c]lassic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally." 634 A.2d at 362.

(n5)Footnote 5. *Rales v. Blasband*, 634 A.2d 927 (*Del. 1993*).

(n6)Footnote 6. *Rales*, 634 A.2d at 936. See also *In re the Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 354 (*Del. 1998*) (citing the definition of interest in *Rales*).

(n7)Footnote 7. *Cede*, 634 A.2d at 364.

(n8)Footnote 8. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (*Del. 1995*).

(n9)Footnote 9. *Cinerama*, 663 A.2d at 1167. In *Cede*, the Delaware Supreme Court had rejected the use of an objective "reasonable person" standard for determining the materiality of a given director's self-interest in a challenged corporate transaction. The court stated that "the reasonable person standard ... has no applicability where there is a breach of the duty of loyalty." *Cede*, 634 A.2d at 364 & n.31.

(n10)Footnote 10. *Cinerama*, 663 A.2d at 1167 (quoting the decision below, 663 A.2d 1134, 1151-52 (*Del. Ch. 1994*)).

(n11)Footnote 11. A director's interest in maintaining his or her office following a transaction does not, in and of itself, constitute a disabling personal interest under Delaware law. See, e.g., *Gantler v. Stephens*, C.A. No. 132, 2009 Del. LEXIS 33, *24-25 (*Del. Jan. 27, 2009*) (claims that directors had an entrenchment motive solely because they could lose their positions following an acquisition are tautological; plaintiffs must plead, in addition to a motive to retain corporate control, other facts sufficient to state a cognizable claim that directors acted disloyally); *Shaper v. Bryan*, 864 N.E.2d 876, 885 (*Ill. App. 2007*) (under Delaware law) ("Delaware law has routinely rejected the notion that a director's interest in maintaining his office is a debilitating factor.") (citing *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 175 (*Del. 2005*)).

(n12)Footnote 12. To illustrate his analysis in *Orman*, the Chancellor discussed, by way of example, a case where a plaintiff shareholder of company X, which is to merge with company Z, challenges the vote of director A, who is both a director and officer of company X, in favor of recommending shareholder approval of the merger. The Chancellor stated that, if one of the terms of the merger agreement was that director A was to be an officer in surviving company Z, and that maintaining his position as a corporate officer in the surviving company was material to director A, those facts, when considered in light of all the facts alleged, might lead the court to conclude that director A had a disabling interest. *Orman*, 794 A.2d 5. at 25.

(n13)Footnote 13. *Aronson*, 473 A.2d at 816 .

(n14)Footnote 14. *Aronson*, 473 A.2d at 816 (quoting *Kaplan v. Centex Corp.*, 284 A.2d 119, 123 (Del. 1971)) .

(n15)Footnote 15. *Aronson*, 473 A.2d at 815 . See also *Rales*, 634 A.2d at 936 (explaining that lack of independence may be shown when a plaintiff alleges facts that show "that the directors are 'beholden' to the [controlling person] or so under their influence that their discretion would be sterilized").

(n16)Footnote 16. *Orman*, 794 A.2d at 25 n.50 .

(n17)Footnote 17. *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000) .

(n18)Footnote 18. *Orman*, 794 A.2d at 25 .

(n19)Footnote 19. *Kohls v. Duthie*, 765 A.2d 1274 (Del. Ch. 2000) .

(n20)Footnote 20. *Kohls*, 765 A.2d at 1277 .

(n21)Footnote 21. *Kohls*, 765 A.2d at 1284 & n.19 (quoting *State of Wis. Inv. Bd. v. Bartlett*, C.A. 17727, 2000 Del. Ch. LEXIS 42, at *20 (Del. Ch. Feb. 24, 2000)) . But see *California Public Employees Ret. Sys. v. Coulter*, C.A. 19191, 2002 Del. Ch. LEXIS 144, at *29 (Del. Ch. Dec. 18, 2002) (taken together, allegations of personal friendships, outside business relationships and approval of or acquiescence in challenged transactions were sufficient to raise inference of lack of independence).

(n22)Footnote 22. *Kohls*, 765 A.2d at 1284-85 .

(n23)Footnote 23. *Kohls*, 765 A.2d at 1285 .

(n24)Footnote 24. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) .

(n25)Footnote 25. *Oracle*, 824 A.2d at 921 .

(n26)Footnote 26. *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) .

(n27)Footnote 27. *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808 (Del. Ch. 2005) .

(n28)Footnote 28. *Orman v. Cullman*, 794 A.2d 5, 22 (Del. Ch. 2002) (quoting *Crescent/Mach Partners, L.P. v. Turner*, 846 A.2d 963, 979 (Del. Ch. 2000) and citing *Cinerama*, 663 A.2d at 1168).

(n29)Footnote 29. *Cinerama*, 663 A.2d at 1168 . See also *McMillan v. Intercargo Corp.*, 768 A.2d 492, 503 (Del. Ch. 2000) ("The independence and disinterestedness of five of the eight directors is unchallenged. The presence of an unconflicted board majority undercuts any inference that the decisions of the ... board can be attributed to disloyalty."); *McMichael v. U.S. Filter Corp.*, C.A. No. EDCV 99-182, 2001 U.S. Dist. LEXIS 3918, at *45 (C.D. Cal. Feb. 23, 2001) ("Plaintiffs have not alleged facts, which, if true, show that a majority of the Board had any personal interest in the alleged injurious transactions. Indeed, they allege only three of the eleven Directors stood to gain from the ... transaction.") (citing *McMillan*, 768 A.2d at 503); Del. Gen. Corp. L. § 144(a)(1) (a transaction between a corporation and another company in which one or more directors are interested shall not be void or voidable solely for that reason, if the material facts are known to the other directors and the board in good faith authorizes the transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors are less than a quorum).

(n30)Footnote 30. *Cinerama*, 663 A.2d at 1168 (affirming Court of Chancery determination that "if actual self-interest is present and affects a majority of directors approving a transaction, the entire fairness standard applies").

(n31)Footnote 31. *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001) (en banc).

(n32)Footnote 32. *Malpiede*, 780 A.2d at 1085 .

(n33)Footnote 33. *Malpiede*, 780 A.2d at 1085 .



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Corporate Governance: Law and Practice

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.04

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§ 12.04 Enhanced Scrutiny in the Case of Defensive Actions

[1] *Unocal*

The Delaware courts give enhanced scrutiny to board authorization of defensive actions that make it more difficult for a bidder to acquire a target company.

Some of the older Delaware cases apply a primary purpose test: did the board, in taking the challenged action, act primarily to benefit the corporation or to entrench and perpetuate itself in office? In two relatively early cases involving struggles for corporate control, the Delaware Chancery Court, applying the primary purpose test, approved a repurchase of stock from a notorious corporate raider¹ and the use of corporate funds to repurchase a block of stock held by another company whose president was well known as a proponent of aggressive tactics that threatened the target's normal operations.² The primary purpose test, however, was distressingly subjective, requiring a court to examine what was in the hearts and minds of the directors of the target company.

In 1985, in *Unocal Corp. v. Mesa Petroleum Co.*,³ the Delaware Supreme Court adopted an objective enhanced scrutiny standard to review defensive measures implemented in anticipation of or in response to an unsolicited takeover threat, although in that case the *Unocal* court also referred to the primary purpose test. The court noted that whenever a board takes steps to defeat or deter an unsolicited offer, there is the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."⁴ Accordingly, the court stated that, when a board undertakes defensive measures in anticipation of or in response to a possible takeover attempt, the board has the burden of demonstrating both that (1) it had "reasonable grounds for believing that a danger to the corporate policy and effectiveness existed"⁵ and (2) the defensive measure adopted was "reasonable in relation to the threat posed."⁶ If the board is able to satisfy both elements of this additional test, the directors' actions will be entitled to the protection of the business judgment rule.

The *Unocal* case arose out of Unocal's defense against a hostile tender offer by Mesa Petroleum, headed by T. Boone Pickens, who had made numerous hostile bids. During the pendency of Mesa's tender offer, Unocal sought to make a selective exchange offer for its own shares and to exclude Mesa from participating in that offer. Mesa, already the owner of approximately 13 percent of Unocal's stock, had commenced a two-tier, "front-end-loaded" cash tender offer for 37 percent of Unocal's outstanding shares at \$54 per share. The second tier "back end" of the offer was intended to eliminate remaining publicly held shares through an exchange of "junk bond" securities purportedly worth \$54 per share, but highly subordinated.

Unocal's board met twice, for a total of eleven and a half hours, to consider Mesa's offer and determine how to respond to it. The first meeting, held five days after Mesa had launched its bid, lasted nine and a half hours and featured detailed presentations by counsel concerning the board's state and federal law obligations and by an outside investment banker concerning the inadequacy of the offer. Using slides to outline the valuation techniques employed to analyze recent business combinations in the oil and gas industry, the investment banker opined that Unocal shareholders could expect to receive more than \$60 per share as the minimum cash value from a sale or orderly liquidation of all of Unocal's stock. He also presented various defensive strategies--including a self-tender at \$70 to \$75 per share--that the directors could adopt if they deemed Mesa's offer inadequate and decided to oppose it. The board's outside directors then met separately with the attorneys and financial advisers and determined to advise the board to fight the Mesa bid with a self-tender. Two days later, in a two-hour meeting, the board approved a self-tender for 49 percent of the shares, at \$72 per share.

The board resolved, however, to exclude Mesa from the offer and thus to deny Mesa the opportunity to tender to Unocal, at \$72 per share, Mesa's holdings of Unocal stock.ⁿ⁷ As the court explained:

Legal counsel advised that under Delaware law Mesa could only be excluded for what the directors reasonably believed to be a valid corporate purpose. The directors' discussion centered on the objective of adequately compensating shareholders at the "back-end" of Mesa's proposal, which the latter would finance with "junk bonds". To include Mesa would defeat that goal, because under the proration aspect of the exchange offer (49 percent) every Mesa share accepted by Unocal would displace one held by another stockholder. Further, if Mesa were permitted to tender to Unocal, the latter would in effect be financing Mesa's own inadequate proposal.ⁿ⁸

Mesa sued to enjoin the selective exchange offer and obtained a preliminary injunction. The Delaware Supreme Court reversed.

The court held that Unocal's directors had authority under Delaware law to deal selectively with the corporation's shareholders, "provided the directors have not acted out of a sole or primary purpose to entrench themselves in office."ⁿ⁹ Moreover, the board had a "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source."ⁿ¹⁰ The court then proceeded to examine whether the directors had acted in good faith to fulfill their duty of loyalty to Unocal and its shareholders or whether they primarily had sought to perpetuate their own tenure.

The court concluded that the board had acted with a valid purpose: the directors' intent was either to defeat what they reasonably believed to be an inadequate offer or, in the alternative, to provide \$72 worth of senior debt to the 49 percent of Unocal's shareholders who, in the second tier of Mesa's offer, otherwise would be forced to accept "junk bonds" worth far less than \$54. The court also recognized that Mesa's two-tier, "front-loaded" offer was:

a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction. Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a "greenmailer."ⁿ¹¹

The fact that Mesa would be excluded from participating in the offer did not render the directors' actions improper, for inclusion of Mesa would have negated the very purposes behind the self-tender: it would have compelled Unocal effectively to subsidize Mesa's continuing effort to buy Unocal at \$54 per share and would have allowed Mesa to reap the same benefits allotted to the other shareholders, whom the board sought to protect from Mesa's own coercive and inadequate offer. "The board," observed the court, "continues to owe Mesa the duties of due care and loyalty. But in the face of the destructive threat Mesa's tender offer was perceived to pose, the board had a supervening duty to protect the corporate enterprise, which includes the other shareholders, from threatened harm."¹² The board thus had fulfilled its duties to Unocal and its shareholders. The case law after *Unocal* gives guidance as to what is needed to satisfy the *Unocal* test and, in the process, has made it easier to show whether a threat exists and whether the reaction to the threat is reasonable.

[2] Are There Reasonable Grounds for Believing There is a Danger to Corporate Policy and Effectiveness?

The cases make clear that the board can find a threat, even if no one has actually launched a takeover, if there is a possibility that a takeover attempt will be made.¹³

In *Paramount Communications, Inc. v. Time, Inc.*,¹⁴ the Delaware Supreme Court, upheld, under *Unocal*, Time's response to a cash tender offer by Paramount, noting Time's arguments that the Paramount bid was inconsistent with a proposed combination between Time and Warner Brothers that was necessary to implement Time's long-term business plans and its views as to which combination provided the best strategic fit with Time's policy and culture.

Time had entered into a negotiated stock merger with Warner. Time's board of directors had determined to search for a strategic alliance to allow it to expand further into entertainment from its original journalistic base. Time's board was concerned about preserving Time's culture, including its commitment to journalistic integrity. Time's board determined that an alliance with Warner would best fit with Time's existing businesses. Moreover, under the merger agreement, the "Time culture" was to be preserved by elaborate provisions relating to the composition of the board and the selection of the chief operating officer of the combined company.

Paramount made a hostile offer of \$175 per Time share (later raised to \$200 per share) (Time stock had been trading at about \$126 per share), contingent on Time's calling off its proposed merger with Warner. The Time board rejected Paramount's bid, and instead restructured its merger with Warner to be accomplished, without a vote by Time's shareholders, by an immediate all-cash tender offer for 51 percent of Warner's outstanding stock at \$70 per share, the remaining 49 percent to be purchased at some later date for a mixture of cash and securities worth \$70 per share.

Paramount brought suit to enjoin the revised Time-Warner merger, arguing that Time's board had breached its fiduciary duties under *Unocal*. Paramount argued that since its tender was an all cash offer for all shares, its offer did not represent a threat to Time's shareholders, and accordingly, defensive tactics were unwarranted under *Unocal*.

The Delaware Supreme Court declined to enjoin the revised Time-Warner merger. The court rejected Paramount's proposed rule of law, extrapolated from some earlier Chancery Court decisions, "that an all-cash, all-shares offer with values reasonably in the range of acceptable price cannot pose any objective threat to a corporation or its shareholders."¹⁵ According to the Delaware Supreme Court, the Chancery Court cases cited by *Paramount-Time*¹⁶ fundamentally misconceived the *Unocal* standard of review, in that they "would involve the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors."¹⁷ The Delaware Supreme Court also rejected the concept that current or discounted future price for shares should be the only standard taken into account by a board in evaluating a threat under *Unocal*. Instead, the board must be free to examine the "nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders ... the risk of nonconsummation, and the quality of securities being offered in the exchange."¹⁸ The court stated in broad language:

The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to stockholders ...Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.¹⁹

The *Paramount-Time* decision indicates that careful articulation of a corporate strategy, including the strategic advantages of a particular merger, may help a board in taking action to defend the strategy, because it may help to establish a threat under *Unocal*. The court in *Paramount-Time* relied on Time's having charted its strategic corporate goals in advance of the events that led to the litigation, and on the fact that Time's directors decided to stay on that strategic course despite the intervention of Paramount's cash tender offer.²⁰

The directors may satisfy the first element of the *Unocal* test--reasonable grounds to believe there is a danger to corporate policy and effectiveness--"by showing good faith and reasonable investigation."²¹ Evidence of their good faith and reasonable investigation is "materially enhanced" if a majority of the directors approving the defensive action consists of outside independent directors.²² In such cases, plaintiffs bear a "heavy burden of overcoming the presumptions thus attaching to the board's decisions."²³

In *Mills Acquisition Co. v. MacMillan, Inc.*,²⁴ the Delaware Supreme Court provided a non-exclusive list of factors that the board of a target company might consider in conducting a reasonable investigation as to whether a particular takeover offer constituted a threat to corporate policy and effectiveness. The court stated that the board should engage in an analysis that considers:

among various proper factors, the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of non-consummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.²⁵

In *Unitrin, Inc. v. American General Corp.*,²⁶ the Delaware Supreme Court considered defensive actions taken by Unitrin in response to an offer by American General to buy all of Unitrin for \$2.6 billion, about 30 percent above the then market price. In response to the American General offer, Unitrin adopted a poison pill, amended its bylaws to require advance notice for actions proposed by shareholders, and also authorized the repurchase of close to 20 percent of its outstanding shares--a repurchase program that would increase the percentage ownership of Unitrin's directors so as to enable them to block a merger with a more-than-fifteen-percent owner, under a supermajority provision in Unitrin's charter, unless the merger was approved by Unitrin's continuing directors.

The Chancery Court entered a temporary restraining order and a preliminary injunction against repurchases by Unitrin of its own shares, on the grounds that the repurchase program was "unnecessary" and therefore a disproportionate response to the threat posed by American General. The Delaware Supreme Court reversed. In analyzing whether there was a threat that warranted a defensive response, the Delaware Supreme Court noted three types of threats:

- *opportunity loss*, where a hostile offer might deprive target shareholders of the opportunity to select a superior alternative;
- *structural coercion*, in that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions; and
- *substantive coercion*, the risk that shareholders will mistakenly accept an underpriced offer because

they do not believe management's representations of intrinsic value.ⁿ²⁷

According to the court, the record appeared to support the conclusion that Unitrin's board reasonably perceived American General's offer to involve a threat of substantive coercion: that shareholders might accept American General's inadequate offer because of ignorance or mistaken belief as to the board's assessment of the stock's long-term value. Stock of the target was moving into hands of arbitrageurs, and the board had found that the market was undervaluing the target's stock.ⁿ²⁸

The *Unocal* test would also be applicable if parties to a negotiated merger take actions to defend against the possibility of a competing bid. That has long been recognized if the actions are taken in response to an actual competing bid.ⁿ²⁹ More recently, case law has suggested that deal protection provisions such as covenants not to talk to others and "break-up fees" payable if one party terminates in order to accept a better transaction should be subjected to enhanced scrutiny under *Unocal*, as defensive actions taken in response to the possibility of a competing transaction.ⁿ³⁰ Finally, the majority in the Delaware Supreme Court's decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*,ⁿ³¹ held that deal protection devices put in place to protect a stock-for-stock merger even in the absence of an active threat are subject to enhanced scrutiny under the *Unocal* test.

[3] Is the Defensive Response Reasonable in Relation to the Threat Posed?

In *Unitrin*, the Chancery Court had enjoined a repurchase program undertaken in response to an offer to buy the whole company because the response was not "necessary." The Delaware Supreme Court reversed, in effect holding that the Chancery Court's application of *Unocal* placed too great a burden on the directors of the target company. According to the Delaware Supreme Court, the Chancery Court should have reviewed first whether the repurchase program was "draconian, by being either preclusive or coercive," and second, if not, whether it was "within a range of reasonable responses to the threat ... posed."ⁿ³²

The *Unitrin*, court noted that the lower court had mistakenly concluded that the effect of the repurchase program would be to preclude the possibility of a successful proxy contest by American General to take over Unitrin. In fact, so long as a bidder did not buy more than 15 percent of Unitrin's stock, it would be able to wage a proxy contest to elect directors who could redeem the poison pill and approve a merger that would require for its approval only a bare majority of Unitrin's stock. The court also pointed out that, even if the director-stockholders increased their stockholdings as a result of the repurchase program, it could not be presumed that the desire to remain on the board would prevail over a stockholder-director's economic interest. In the court's view, it did not appear that the repurchase program would have a preclusive effect on a proxy contest, or that a limited non-discriminatory self-tender or repurchase program would be inherently coercive.ⁿ³³

If a defensive measure is found not to be preclusive or coercive, the court should not substitute its business judgment for that of the target company directors in assessing whether the defensive measure was reasonable in relation to the threat posed. Rather, it should determine only whether the measure fell within a "range of reasonableness."ⁿ³⁴

While the Delaware Supreme Court sent the case back to the Chancery Court to assess the defensive measure under these tests, it did note broadly that a board needs "latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats," and pointed out a concomitant need for judicial restraint.ⁿ³⁵

The *Unitrin* court indulged in an extended image of medieval defensive warfare:

When a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders [I]f a board reasonably perceives that a threat is on the horizon, it has broad authority to respond with a panoply of individual or combined defensive precautions, e.g., staffing the barbican, raising the drawbridge, and lowering the

portcullis. Stated more directly, depending upon the circumstances, the board may respond to a reasonably perceived threat by adopting individually or sometimes in combination: advance notice by-laws, supermajority voting provisions, shareholder rights plans, repurchase programs, etc.ⁿ³⁶

The Delaware Supreme Court instructed the lower court, in determining whether the repurchase program was within the range of reasonableness, to take into consideration whether:

(1) it is a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover context; (2) as a defensive response to American General's offer it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat ...; (3) with the Repurchase Program, the Unitrin Board properly ... provided immediate liquidity to those shareholders who wanted it.ⁿ³⁷

The court strongly hinted--by citing with approval an earlier case upholding a repurchase program and other measures adopted by Polaroid in response to a takeover bid--that the defensive measures taken by Unitrin were within a range of reasonableness.ⁿ³⁸

The Chancery Court never decided the question of the reasonableness of the repurchase program on remand, as American General determined not to press its pursuit of Unitrin.

In its decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*,ⁿ³⁹ the Delaware Supreme Court applied the initial *Unitrin* test in a way that did not lessen the burden placed on target directors by *Unocal*. In *Omnicare*, the court elaborated on when a response is "preclusive" or "coercive," as follows:

... A response is "coercive" if it is aimed at forcing upon stockholders a management- sponsored alternative to a hostile offer.

... A response is "preclusive" if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise.ⁿ⁴⁰

Omnicare involved a challenge to the proposed merger between Genesis Health Ventures, Inc. and NCS Healthcare, Inc., a public corporation on the brink of insolvency. Genesis and NCS had entered into a merger agreement, pursuant to which NCS's creditors were to be paid in full and NCS's stockholders were to exchange their shares for the shares of Genesis.

The merger agreement contained a provision, authorized by the Delaware corporation law, requiring that the merger be placed before the NCS stockholders for a vote even if NCS's board of directors no longer recommended approval of the merger. In addition, two stockholders of NCS, who held a majority of its voting power, had agreed unconditionally to vote their shares in favor of the merger, making it a certainty that the merger would be approved by the stockholders. Genesis had insisted on a firm lock-up as a condition of its willingness to enter into a transaction with NCS.

Thereafter, *Omnicare, Inc.* made an acquisition proposal to the board of NCS, pursuant to which the stockholders of NCS would receive consideration of greater value than they would receive under the merger agreement with Genesis. As a result, the NCS board withdrew its prior recommendation that the stockholders approve the merger agreement with Genesis, and NCS's financial advisers withdrew their fairness opinion. Shareholders brought a class action to enjoin the merger with Genesis.

The Chancery Court concluded that "the directors acted in conformity with their fiduciary duties in seeking to achieve the highest and best transaction that was reasonably available to them."ⁿ⁴¹ On appeal, the Delaware Supreme Court reversed, holding that the deal protection provisions were invalid under *Unocal*, on two separate grounds.

First, the court reviewed the deal protection provisions under the *Unocal* test. The court held that enhanced scrutiny should apply to deal protection provisions because "[t]he stockholders' ability to effectively reject a merger agreement is likely to bear an inversely proportionate relationship to the structural and economic devices that the board has approved to protect the transaction."ⁿ⁴² Applying *Unocal*, the court examined whether the board's response to a reasonably perceived threat--in this case, agreeing to the lock-up provisions to keep Genesis from making good on its threat to terminate discussions--was reasonable in relation to the threat. The court explained that to sustain the defensive measure under *Unocal*, the court must first determine that the devices are not "preclusive" or "coercive," and then determine that they are within a "range of reasonable responses" in relation to the threat posed. The court found the lock-up given to Genesis to be both preclusive and coercive. According to the majority, the lock-up arrangements "accomplished a fait accompli" and were "designed to coerce the consummation of the Genesis merger and preclude the consideration of any superior transaction."ⁿ⁴³ The court noted that the combination of the firm requirement to submit the merger to a stockholder vote, the voting agreements and the absence of an effective fiduciary out made it impossible and unattainable "for the Omnicare transaction or any other transaction to succeed, no matter how superior the proposal."ⁿ⁴⁴

The court also found the deal protection provisions to be invalid on a separate basis: they prevented the NCS directors from exercising their continuing fiduciary duties to minority stockholders. By agreeing to the fully locked-up deal, the NCS board "disabled itself from exercising its own fiduciary obligations at a time when the board's own judgment is most important, i.e. receipt of a subsequent superior offer."ⁿ⁴⁵ Acknowledging that boards may agree to merger protection devices that are "economic and reasonable," even if they increase the cost to a competing bidder, the majority stated that defensive measures "cannot limit or circumscribe the directors' fiduciary duties," which the court described as "unremitting."ⁿ⁴⁶ The court held that the NCS board had no authority to approve a merger agreement that prevented it from executing its ongoing fiduciary responsibilities, and that the board was "required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities."ⁿ⁴⁷

The Delaware Chancery Court's subsequent decision in *Orman v. Cullman* ⁿ⁴⁸ suggests that courts will apply *Omnicare* narrowly. In *Orman*, the court declined to invalidate, on *Omnicare* grounds, a controlling stockholder's voting agreement that precluded the possibility of completing a competing deal for 18 months.

The Cullman family, controlling stockholders of General Cigar, agreed to vote for a transaction in which Swedish Match would acquire half the Cullman family's interest and the public shareholders' interest in General Cigar. After the merger, General Cigar would be owned 64 percent by Swedish Match and 36 percent by the Cullmans, although two members of the Cullman family would remain in control of General Cigar's operations.

The transaction, approved by a special committee of General Cigar's board, was conditioned on approval by a majority of the shares held by the public. The Cullmans, whose high-vote Class B shares gave them voting control over General Cigar but not a majority economic interest, agreed not to sell their shares and to vote their shares against any alternative proposal, for a specified period after termination of the merger agreement between General Cigar and Swedish Match. The period was originally to be one year, but was increased to 18 months after Swedish Match agreed to improve the deal price by \$0.25, to \$15.25 per share--a 75 percent premium over the market price. The public shareholders approved the transaction.

Chancellor Chandler then applied a *Unocal* analysis, as required by *Omnicare*, to determine whether the deal protection mechanisms were adopted in response to a reasonably perceived threat and whether they were "coercive." The Chancellor noted that the plaintiff had not argued that the lockup was "preclusive" under *Unocal*, and so only coercion was at issue.

Chancellor Chandler concluded that the first prong of *Unocal* was easily satisfied: the General Cigar board risked losing the transaction if it did not accede to the lockup, since Swedish Match said it would not proceed without deal protection.

Turning to the second prong, the Chancellor decided the deal protection measures were not coercive because they do not "cause the vote to turn on factors extrinsic to the merits of the transaction."ⁿ⁴⁹

Chancellor Chandler distinguished the deal protection devices in *Omnicare*, which made approval of the Genesis/NCS merger a "*fait accompli*" from the ones before it: the *Omnicare* merger was required to go to a shareholder vote even if the NCS board withdrew its recommendation, and NCS's controlling shareholders had entered into a watertight voting agreement, making the NCS board's ability to change its recommendation meaningless. In contrast, the General Cigar board's ability to change its recommendation was meaningful, since the public shareholders could reject the merger - "even though, permissibly, their vote may have been influenced by the existence of the deal protection measures."ⁿ⁵⁰ The Chancellor also noted that, unlike in *Omnicare*, "there was no competing bid for General Cigar."ⁿ⁵¹

Chancellor Chandler acknowledged that the Cullmans' agreement to vote against alternative deals for 18 months meant that "[i]t was this deal or nothing, at least for that period of time," but questioned whether an 18 month delay was "a meaningful 'cost' that could be said realistically to 'coerce' the shareholders' vote."ⁿ⁵² He also questioned whether "it is fair to say that a minority was coerced by a voting and ownership structure that was fully disclosed to the minority before they bought into a corporation whose capital structure was so organized."ⁿ⁵³ Ultimately, the Chancellor concluded that the coercion being complained of resulted from the fact that the Cullmans owned a controlling interest, and declined to hold that "being in a voting minority automatically means that the shareholder is coerced."ⁿ⁵⁴

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Defenses Business & Corporate Law Corporations Directors & Officers Scope of Authority Limitations

FOOTNOTES:

(n1)Footnote 1. *Cheff v. Mathes*, 199 A.2d 548, 556 (Del. 1964) .

(n2)Footnote 2. *Kors v. Carey*, 158 A.2d 136, 141 (Del. Ch. 1960) .

(n3)Footnote 3. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) .

(n4)Footnote 4. *Unocal*, 493 A.2d at 954 .

(N5)Footnote 5. *Unocal*, 493 A.2d at 955 .

(n6)Footnote 6. *Unocal*, 493 A.2d at 955 .

(n7)Footnote 7. This technique would no longer be permissible as a result of the SEC's adoption in 1986 of Rule 14d-10, which requires that tender offers be open to all holders of the class of securities subject to the tender offer. 17 CFR § 240.14d-10.

(n8)Footnote 8. *Unocal*, 493 A.2d at 951 .

(n9)Footnote 9. *Unocal*, 493 A.2d at 954 .

(n10)Footnote 10. *Unocal*, 493 A.2d at 954 .

(n11)Footnote 11. *Unocal*, 493 A.2d at 956 (footnotes omitted).

(n12)Footnote 12. *Unocal*, 493 A.2d at 958 .

(n13)Footnote 13. See, e.g., *Williams v. Geier*, 671 A.2d 1368, 1377 n.18 (Del. 1996) ("The fact that no company

or person has commenced a specific takeover threat or action at the time of the defensive measure's adoption does not preclude application of the *Unocal* analysis if it is otherwise applicable.") (quoting *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985)); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985) (holding that a defensive mechanism--a poison pill--adopted to ward off possible future advances and not in reaction to a specific threat does not lose the protection of the business judgment rule); *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 478 (Del. Ch. 2000) (holding that expiration of a dual class voting structure that entitled the CEO of the corporation, a shareholder who owned or controlled a majority of the corporation's Class B stock, to a majority of all votes of the corporation's common shareholders created a threat to the corporation, justifying a defensive response, even though no tender offer was imminent, and stating that "Delaware law does not require a board to wait until the eve of battle to consider the erection of sound defensive barriers"); *Tomczak v. Morton Thiokol, Inc.*, C.A. 7861, 1990 Del. Ch. LEXIS 47, at *26 (Del. Ch. Apr. 5, 1990) (applying the *Unocal* test to the decision of the defendant directors to sell a company division in response to a possible "creeping" tender offer).

(n14)Footnote 14. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) .

(n15)Footnote 15. *Paramount-Time*, 571 A.2d at 1152 .

(n16)Footnote 16. The cases cited were *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) (while repurchase plan in connection with employee stock ownership plan was a defensive measure adopted in response to a valid threat, it was a tactic that was not reasonable in relation to the threat posed by an "any and all cash tender offer," because it effectively squelched the offer); *Grand Metropolitan, plc v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988) (board's refusal to redeem poison pill and board's attempt to spin off a subsidiary were not reasonable defensive tactics in the face of an "all shares and all cash and wholly financed" tender offer, even if there was a risk to the 12-13 percent non-tendering minority of receiving less than the price received by the tendering shareholders); *City Capital Associates. Ltd. Part. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988) (board's refusal to redeem poison pill was an unreasonable defensive tactic in response to a cash tender offer for all shares, although the restructuring plan, including sale of a division and a substantial dividend of cash and securities, were found to be reasonable responses to an inadequate offer).

(n17)Footnote 17. *Paramount-Time*, 571 A.2d at 1153 .

(n18)Footnote 18. *Paramount-Time*, 571 A.2d at 1153 (quoting *Unocal*, 493 A.2d at 955) .

(n19)Footnote 19. *Paramount-Time*, 571 A.2d at 1154 .

(n20)Footnote 20. *Paramount-Time*, 571 A.2d at 1154-55 .

(n21)Footnote 21. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (quoting *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548, 555 (Del. 1964)) .

(n22)Footnote 22. *Unocal*, 493 A.2d at 955 ; *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1375 (Del. 1995) .

(n23)Footnote 23. *Polk v. Good*, 507 A.2d 531, 537 (Del. 1986) .

(n24)Footnote 24. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989) .

(n25)Footnote 25. *Mills*, 559 A.2d at 1282 n.29 .

(n26)Footnote 26. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995) .

(n27)Footnote 27. *Unitrin*, 651 A.2d at 1384 .

(n28)Footnote 28. *Unitrin*, 651 A.2d at 1384 .

(n29)Footnote 29. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1989) .

(n30)Footnote 30. See *McMillan v. Intercargo Corp.*, 768 A.2d 492, 505-506 & nn. 61-63 (Del. Ch. 2000) (deal protection terms will be considered defensive and reviewed under *Unocal*; however, as long as such provisions are non-preclusive, non-coercive, and otherwise within the boundaries of reason, Delaware law will generally recognize them as valid); *Hills Stores Co. v. Bozic*, 769 A.2d 88, 93 (Del. Ch. 2000) (a termination fee payable in the event of a negative stockholder vote on a merger places an economic toll on the franchise, and therefore, Delaware law has traditionally reviewed the propriety of such fees under the *Unocal* or *Revlon* standards depending on the circumstances, or under a comparable liquidated damages standard); *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 & n.42 (Del. Ch. 1999) (when corporate boards assent to no-shop, no-talk or termination fee provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the policy concerns that animate the *Unocal* standard of review might be implicated); *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. 17398, 1999 Del. Ch. LEXIS 202, at *4 (Del. Ch. Sept. 27, 1999) ("No-talk provisions ... are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party"); *Goodwin v. Live Entertainment, Inc.*, C.A. 15765, 1999 Del. Ch. LEXIS, at *69-70 (Del. Ch. Jan. 22, 1999) (upholding a 3.125 percent termination fee in a merger agreement as not being unreasonable under the *Unocal* standard). See also *Brazen v. Bell Atlantic Corp.*, 695 A.2d 43 (Del. 1997) , where the Delaware Supreme Court held that a termination fee in a merger agreement should be analyzed as a liquidated damages provision if the merger agreement specifically so provides, and therefore, a test that requires determining whether the amount agreed upon is "within a range of reasonableness" should be applied to such provisions, rather than the business judgment rule. In *Hills Stores*, 769 A.2d 88, 104 , Vice Chancellor Strine stated that the liquidated damages standard used in the *Brazen* case is comparable to the *Unocal* standard.

(n31)Footnote 31. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) . The *Omnicare* decision discussed in greater detail in 12.05[1] below . See also *Orman v. Cullman*, C.A. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004) (following *Omnicare* in applying a *Unocal* analysis to determine whether a lock-up was a reasonable response to a reasonably perceived threat).

(n32)Footnote 32. *Unitrin*, 651 A.2d at 1385-88 .

(n33)Footnote 33. *Unitrin*, 651 A.2d at 1388 . See also *Orman v. Cullman*, C.A. No. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004) (holding not coercive a voting agreement locking up a majority of the voting power that would prevent its holder from voting for a competing bid for 18 months after termination of the merger agreement with the first bidder). But cf. *Omnicare*, 818 A.2d 914 (holding preclusive and coercive the combination of a voting agreement locking up a majority of the target's stock and a requirement in the merger agreement that the merger be put to a stockholder vote even if the target board no longer recommended approval of the merger).

(n34)Footnote 34. *Unitrin*, 651 A.2d at 1388 (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A. 2d 34, 45-46 (Del. 1994)) . It should also be noted that defensive mechanisms must be properly adopted. For example, in *Goldstein v. Lincoln Nat'l Convertible Securities Fund, Inc.*, 140 F. Supp. 2d 424 (E.D. Pa. 2001) , the court held that, under Maryland law, an advance notice provision in a fund's proxy statement, but not in the fund's bylaws or charter, was unenforceable.

(n35)Footnote 35. *Unitrin*, 651 A.2d at 1388 .

(n36)Footnote 36. *Unitrin*, 651 A.2d at 1388 & n.38.

(n37)Footnote 37. *Unitrin*, 651 A.2d at 1389 (footnotes omitted).

(n38)Footnote 38. *Unitrin*, 651 A.2d at 1389 .

(n39)Footnote 39. *Omnicare, Inc. v. NCS Healthcare, Inc*, 818 A.2d 914 (Del. 2003) .

(n40)Footnote 40. *Omnicare*, 818 A.2d at 935 .

(n41)Footnote 41. *In re NCS Healthcare, Inc., S'holders Litig.*, 825 A.2d 240, 261 (Del. Ch. 2002) .

(n42)Footnote 42. *Omnicare*, 818 A.2d at 930 .

(n43)Footnote 43. *Omnicare*, 818 A.2d at 936 .

(n44)Footnote 44. *Omnicare*, 818 A.2d at 936 .

(n45)Footnote 45. *Omnicare*, 818 A.2d at 938 .

(n46)Footnote 46. *Omnicare*, 818 A.2d at 938 .

(n47)Footnote 47. *Omnicare*, 818 A.2d at 939 . Omnicare's bright-line requirement for a fiduciary out has caused some parties seeking increased deal certainty to attempt to shorten the period between signing the merger agreement and obtaining stockholder approval for the merger. In a 2008 case, the Court of Chancery declined to enjoin a merger agreement that permitted the acquirer to terminate the agreement if target shareholder approval was not obtained within 24 hours after the merger agreement was signed. The merger agreement was approved by the target's board of directors on the day of signing and was adopted by written consent of the target's stockholders later that day. *Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008).

(n48)Footnote 48. *Orman v. Cullman*, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004) .

(n49)Footnote 49. *Orman*, 2004 Del. Ch. LEXIS, at *33 .

(n50)Footnote 50. *Orman*, 2004 Del. Ch. LEXIS, at *31 .

(n51)Footnote 51. *Orman*, 2004 Del. Ch. LEXIS, at *34 .

(n52)Footnote 52. *Orman*, 2004 Del. Ch. LEXIS, at *36 .

(n53)Footnote 53. *Orman*, 2004 Del. Ch. LEXIS, at *33 .

(n54)Footnote 54. *Orman*, 2004 Del. Ch. LEXIS, at *36 .



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Corporate Governance: Law and Practice

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.05

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§ 12.05 Enhanced Scrutiny in the Case of a Sale of Control**[1] *Revlon***

In 1985, in *Revlon, Inc. v. MacAndrews & Forbes, Inc.*,ⁿ¹ the Delaware Supreme Court articulated a different form of enhanced scrutiny standard for reviewing transactions involving a sale of control or a break-up of the company. Once a target company's board decides to sell the company, the court said the role of directors changes "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."ⁿ² The obligation of the directors then becomes to act reasonably to seek the transaction offering the highest value reasonably available to the stockholders.ⁿ³

The *Revlon* case arose out of Pantry Pride's dogged effort to acquire Revlon--an effort that had begun well before Pantry Pride announced, on August 14, 1985, that it would make a hostile tender offer for Revlon at \$45 per share. The Revlon board met five days later and, on the advice of the company's investment bankers, concluded that the Pantry Pride proposal was inadequate. The investment bankers also explained that Pantry Pride intended to finance the tender offer with "junk bonds," followed by a break-up of Revlon and disposition of its assets (a "bust-up" tender offer). At the recommendation of its attorneys, Revlon adopted two defensive measures: a "poison pill" and a stock repurchase plan.

On August 23, Pantry Pride commenced its cash tender offer for any and all shares of Revlon at \$47.50 per common share and \$26.67 per preferred share. Revlon's board advised shareholders to reject the offer and commenced the stock repurchase program, exchanging for each tendered share of common stock one Senior Subordinated Note (the "Notes") and one-tenth of a share of Cumulative Convertible Exchangeable Preferred Stock. In response to these maneuvers, Pantry Pride announced a new tender offer and ultimately raised its bid to \$53 per share.

Meanwhile, Revlon hunted around for an appropriate "white knight" and finally found one: Forstmann Little & Co. On

October 3, the Revlon board agreed to a leveraged buy-out ("LBO") of the company by Forstmann at \$56 per share. The plan also involved selling off various Revlon divisions to facilitate the acquisition. To effectuate this scheme, the Revlon board agreed to waive certain covenants contained in the Notes, which limited Revlon's ability to sell assets. When the company announced the waiver of the covenants, the market value of the Notes fell sharply, and noteholders complained and threatened litigation.

Pantry Pride still had not lost interest in Revlon and raised its \$53 offer to \$56.25. Pantry Pride also announced its intention to engage in fractional bidding and to top any Forstmann offer by a slightly higher one. Forstmann then raised its own offer to \$57.25 per share, conditioned on (a) a lock-up option to purchase two Revlon divisions at \$100-\$175 million below fair value if another acquiror were to purchase 40 percent of Revlon's shares, (b) a no-shop provision, (c) the removal of the poison pill and the Notes covenants, and (d) a \$25 million cancellation fee. In return, Forstmann agreed to support the faltering market value of the Notes by an exchange of new notes. The Revlon board approved the offer (which was contingent on immediate acceptance) because (i) the offer was higher than Pantry Pride's, (ii) it protected the noteholders, and (iii) Forstmann's financing was in place. Pantry Pride challenged the Revlon agreement and defensive measures; it also raised its own bid to \$58 per share. The trial court granted a preliminary injunction, and the Delaware Supreme Court affirmed.

The court held that the Revlon board had acted reasonably, and in accordance with its fiduciary obligations, in adopting the poison pill and the exchange offer. These measures were taken at the beginning of the battle, in the face of an inadequate offer of \$45 or \$47.50 per share. The pill and the exchange offer undoubtedly were major factors in causing Pantry Pride to raise its bid to an eventual high of \$58 per share and, at least initially, in protecting Revlon from a "bust-up," "junk bond" takeover by a small, highly leveraged company.

In time, however, the corporation's situation--and thus the directors' responsibilities--changed. Instead of keeping the company intact and protecting its shareholders from being stampeded into tendering at an inadequate price, the focus shifted to selling and dismantling the company on the most favorable terms. As the court explained:

[W]hen Pantry Pride increased its offer to \$50 per share, and then to \$53, it became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.ⁿ⁴

In light of the directors' new role as "auctioneers," the court found that the board had breached its "primary duty of loyalty" to Revlon's shareholders by acceding to the lock-up option and the other conditions (the no-shop clause and the cancellation fee) that Forstmann had demanded in exchange for its bid of \$57.25 per share. Once they decided to sell the company, the directors had a duty to obtain "the highest price for the benefit of the stockholders."ⁿ⁵ Forstmann's offer of \$57.25 (contingent on the lock-up) admittedly exceeded Pantry Pride's then-current offer of \$56.25 but only marginally, when adjusted for the time value of money. The Forstmann bid, however, did have one unique feature: Forstmann had promised to shore up the sagging value of the Notes, whose holders were threatening litigation.

But it was precisely this advantage that, according to the court, the board had no right to consider. In exchange for an offer of only marginal superiority, Revlon had granted a lock-up option that effectively ended bidding for the company (despite Pantry Pride's stated intention to top any Forstmann offer), that protected the noteholders, and that saved the directors from litigation--all at the expense of the shareholders, who might have received at least \$58 per share had the lock-up (and the poison pill) been rescinded. In preferring the interests of the noteholders (whose rights already were

fixed by contract and who required no further protection) to those of the shareholders, the board breached its duty of loyalty. Moreover, the board had sacrificed the shareholders' interests to protect their own. "In reality," held the court,

the Revlon board ended the auction in return for very little actual improvement in the final bid. The principal benefit went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstances. Thus, when a board ends an intense bidding contest on an insubstantial basis, and where a significant by-product of that action is to protect the directors against a perceived threat of personal liability for consequences stemming from the adoption of previous defensive measures, the action cannot withstand the enhanced scrutiny which *Unocal* requires of director conduct.ⁿ⁶

The no-shop provision was similarly improper: it ended, rather than enhanced, the bidding contest at a time when the board's primary duty became "that of an auctioneer responsible for selling the company to the highest bidder."ⁿ⁷

The *Revlon* court also observed that "the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance--that the responsive action taken is reasonable in relation to the threat posed."ⁿ⁸ The poison pill and the exchange offer met this proportionality test,ⁿ⁹ but the lock-up and the ancillary agreements did not: they obtained for the shareholders an almost insignificant improvement in the final bid and served only to end the auction for the company.ⁿ¹⁰

[2] What Circumstances Trigger the Duty to Seek the Best Value?

Two decisions by the Delaware Supreme Court involving Paramount Communications, Inc. have helped to clarify when *Revlon* duties apply. The first decision, *Paramount Communications Inc. v. Time, Inc.*,ⁿ¹¹ discussed above in connection with the *Unocal* standard, held that *Revlon* duties were not triggered by the decision by the board of directors of Time to enter into a stock merger with Warner Brothers, or its subsequent decision to revise that merger agreement to provide for a first step tender offer by Time for Warner. Even though Time had decided to merge with Warner, the court found there was no substantial evidence that "Time's board, in negotiating with Warner, made the dissolution or breakup of the corporate entity inevitable, as was the case under *Revlon*."ⁿ¹²

The court identified two circumstances that would implicate *Revlon* duties and so require the board to maximize immediate shareholder value in a sale: "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company" and "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company."ⁿ¹³ In those circumstances, there is a duty on the board "to maximize immediate shareholder value."ⁿ¹⁴ In the *Paramount-Time* case, however, the court found that a sale of Time was never inevitable and that Time never abandoned its corporate strategic plan. As a result, neither of the *Revlon*-triggering circumstances existed.ⁿ¹⁵

The second decision that helped clarify when *Revlon* duties apply was *Paramount Communications, Inc. v. QVC Network Inc.*ⁿ¹⁶ In 1993, the directors of Paramount Communications, Inc. approved a merger agreement with Viacom, Inc., under which Paramount shareholders would receive a package consisting mostly of non-voting Viacom stock, some voting Viacom stock and some cash. If the merger went through, the combined company would have been controlled by Sumner Redstone, Viacom's Chairman and CEO, who would have ended up with approximately 70 percent of the voting stock of the combined company.

The merger agreement contained three obstacles to a competing bid:

... A no-shop provision, under which Paramount would not solicit, encourage, discuss, negotiate or endorse a competing bid unless (i) the competing bidder made an "unsolicited written ... proposal, which is not subject to any material contingencies related to financing" and (ii) the Paramount board determined

that discussions were necessary to comply with its fiduciary duties.

... A termination fee of \$100 million, payable if, among other things, Paramount's directors recommended a competing transaction or Paramount's stockholders did not approve the merger.

... A stock option, allowing Viacom to buy 19.9 percent of Paramount's stock for \$69.14 per share (the value of the Viacom merger consideration) under the same conditions as would trigger payment of the termination fee. In addition to the usual terms of a stock lock-up, this option permitted Viacom to pay all but \$1.00 per share of the exercise price with a note "of questionable marketability." Viacom could also require Paramount to pay Viacom in cash the excess--no matter how great that excess might become--of the then market price of Paramount stock over the option exercise price.

QVC Network Inc. told Paramount it was prepared to buy the whole company on a part-cash, part-stock basis, and brought suit in Delaware seeking to invalidate, among other things, the stock option in favor of Viacom.¹⁷

The Delaware Supreme Court affirmed the Chancery Court decision enjoining exercise of the stock option and also enjoining Paramount from redeeming its poison pill shareholder rights to permit Viacom to close its tender offer without doing the same thing to permit consummation of the QVC offer. According to the Delaware Supreme Court, the directors of a target company are obliged to seek the best price reasonably available to stockholders whenever a corporation undertakes a transaction that will result in either a "change in corporate control" or a "break-up of the corporate entity."¹⁸

[3] How Does the Board Seek the Best Value?

Despite the suggestion in *Revlon* that directors who decide to sell a company become "auctioneers," in *Paramount-QVC* the Delaware Supreme Court noted that there is "no single blueprint" that directors must follow in seeking best value in a sale of control. An auction is one way; signing up with one bidder but with a post-signing canvassing of the market is another. Whatever method is used, however, it must be "designed to determine the existence and viability of possible alternatives."¹⁹

In *Paramount*, the Delaware Supreme Court recognized "the complexity of the directors' task" and the "many business and financial considerations implicated in investigating and selecting the best value reasonably available."²⁰ While emphasizing that the court's role is only to determine "whether the directors made a *reasonable* decision, not a *perfect* decision,"²¹ the court gave some guidance as to how directors should proceed in determining which alternative provides the best value for stockholders.

The board "is not limited to considering only the amount of cash involved" and need not "ignore totally" the future value of a strategic alliance.²² However, if stock or other non-cash consideration is involved, "the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives." The board should "focus on [the] value as of the date it will be received by the stockholders," presumably because future actions by the new majority shareholder could deprive minority shareholders of anticipated future growth in value. Also, the court noted that such value will "normally" be determined "with the assistance of experts using generally accepted methods of valuation."²³ Other considerations relating to alternative offers may also be assessed, including each offer's feasibility, financing, legality and risk of non-consummation, and the bidder's identity and business plans.²⁴

While an auction is not necessary, *Paramount-QVC* makes clear that deal protection measures adopted without a market test must not unduly inhibit the ability of the board of a target to negotiate with other potential bidders to obtain the highest possible value for the target's stock.²⁵ Directors also should not favor a bidder in which they have an interest. In *Mills Acquisition Co. v. MacMillan, Inc.*,²⁶ target directors who were members of management helped a favored bidder, Kohlberg Kravis Roberts & Co. (KKR), to obtain a favorable bidding position by means of a lock-up option. In

enjoining the option, the court emphasized that the inside directors (who would end up with 20 percent of the company if KKR succeeded in its bid), and not the independent directors, controlled the bidding process. According to the court, when the "intended effect" [of a lock-up provision] is to end an active auction, at the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession."ⁿ²⁷

The Delaware Supreme Court discussed the extent and the limitations of the use of a market test by a company in Revlon mode in its decision in *Barkan v. Amsted Industries Inc.*ⁿ²⁸ In *Barkan*, a special committee had failed to conduct a market test, although it had been fully advised by investment bankers, and had negotiated and consummated a management LBO. Noting that Amsted's directors "had acted in good faith to arrange the best possible transaction for shareholders," the *Barkan* court put an interesting and important gloss on *Revlon*:

Revlon does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest. *Revlon* is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders. When multiple bidders are competing for control, this concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another.ⁿ²⁹ When the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, this concern for fairness demands a canvas of the market to determine if higher bids may be elicited.ⁿ³⁰ When, however, the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market [T]he circumstances in which this passive approach is acceptable are limited The need for adequate information is central to the enlightened evaluation of a transaction that a board must make. Nevertheless, there is no single method that a board must employ to acquire such information.ⁿ³¹

Because Amsted had been known to be "in play" for ten months, even though no alternative to the LBO emerged, because the board had reason to understand that the tax advantages of including an employee stock option plan ("ESOP") in the LBO transaction allowed the management group to receive significant tax advantages over other bidders that could be reflected in the price offered to shareholders, and because of a cyclical downturn in Amsted's business that might have discouraged other bidders, the court believed that "the directors could conclude in good faith that they had approved the best possible deal for the shareholders," even though the LBO was the only option.ⁿ³²

Nevertheless, the *Barkan* court appears to have dispensed with the need for a market test in the case before it with reluctance, and it sounded a warning for single bidders who seek to use "no-shop" clauses:

We certainly do not condone in all instances the imposition of the sort of "no-shop" restriction that bound Amsted's Special Committee. Where a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids. Even here, a judicious market survey might have been desirable, since it would have made it clear beyond question that the board was acting to protect the shareholder's interests.ⁿ³³

That there is still uncertainty in this area is underscored by the *Barkan* court's refusal to announce "an iron-clad rule for determining when a market test is not required." Rather, said the court, "[t]he evidence that will support a finding of good faith in the absence of some sort of market test is by nature circumstantial; therefore, its evaluation by a court must be open-textured." Nevertheless, "the crucial element supporting a finding of good faith is knowledge," and "[i]t must be clear that the board had sufficient knowledge of relevant markets to form the basis for its belief that it acted in the best interests of the shareholders."ⁿ³⁴

The Delaware Court of Chancery followed this approach in *In re Pennaco Energy, Inc. S'holders Litig.*,ⁿ³⁵ which

involved a tender offer by an acquisition subsidiary of Marathon Oil for the shares of Pennaco Energy, Inc., at \$19 per share, to be followed by a back-end merger at the same price. In a shareholder action for a preliminary injunction against the closing of the tender offer, Vice Chancellor Strine held that, even though the Pennaco board did not actively shop the company and relied solely on a post-merger agreement market check, its actions were not so deficient under *Revlon* as to justify the entry of an injunction.ⁿ³⁶

The vice chancellor pointed out that the board's actions should be evaluated in the context of the company's market posture. Pennaco was a source of industry interest. It was followed by reputable analysts, communicated with the market in a bullish manner, and freely communicated with interested parties. Previously, the company had done an extensive search for a joint venture partner, which brought it to the attention of a number of industry players, including Marathon, a major energy company with great financial clout. Moreover, the company had reincorporated in Delaware to facilitate its participation in the M&A market.ⁿ³⁷

As important, the court emphasized that the Pennaco board's knowledge of the company had not been seriously challenged. The board was composed of directors with relevant expertise and substantial experience in the energy business. This gave them a sound basis to evaluate the price at which a sale of the company would be advantageous to the Pennaco shareholders. In these circumstances, it was not unreasonable for the Pennaco board to deal with Marathon on an exclusive basis.ⁿ³⁸ The court pointed out that there is no risk-free approach to selling a company, and dealing with one bidder at a time has its own advantages. Accordingly, the mere fact that the board decided to focus on negotiating a favorable price with one bidder and not to seek out other bidders was insufficient to support a breach of fiduciary duty claim.ⁿ³⁹

The *Pennaco* court noted, however, that it "would not commend the Pennaco board's actions as a business school model of value maximization."ⁿ⁴⁰ Moreover, the vice chancellor warned that "there [was] little doubt that the validity of the Pennaco board's decision to proceed in the manner it did would [have been] subject to great skepticism had the board acceded to demand to lock up the transaction from later market competition."ⁿ⁴¹ The opinion went on to say that "if the merger agreement with Marathon contained onerous deal protection measures that presented a formidable barrier to the emergence of a superior offer, the Pennaco board's failure to canvass the market earlier might [have] tilt[ed] its actions toward the unreasonable."ⁿ⁴²

Chancery Court followed *Barkan* in its 2004 decision in *In re MONY Group Inc. S'holder Litig.*ⁿ⁴³ There, the court declined to issue a preliminary injunction against a vote by MONY stockholders on a cash merger with AXA Financial. The plaintiffs' argument for an injunction had been based on claims that MONY's directors breached their fiduciary duties by agreeing to the merger without a pre-signing auction.ⁿ⁴⁴

MONY had been losing money. Its board rejected the idea of a public auction, fearing that a failed auction would expose its weaknesses and furnish competitors with information that could be used to steal its career agents. The board authorized discussions with AXA, a large company with a similar business model. MONY's CEO also spoke to the CEO of New York Life, but those discussions did not lead to an offer.

AXA offered \$26.50 per share in cash, after taking into account the roughly \$163 million payable to MONY management under change in control agreements. In May 2003, MONY's board rejected an AXA proposal for a stock merger. Thereafter the board, after getting advice from a compensation consultant, negotiated with MONY management a reduction (to \$79 million) in the amounts payable in their change in control payments. In September 2003, AXA and MONY agreed to a cash merger at \$31 per MONY share. The merger agreement included a broad "window-shop" provisionⁿ⁴⁵ and a "fiduciary out" termination clause. In the five months following announcement of the merger, no one made a competing proposal.

The plaintiffs alleged that the director defendants breached their duties under *Revlon* to get the best possible price for MONY. The court found that the *Revlon* claim lacked merit, noting that the Delaware Supreme Court in *Barkan* had

held that a target's board could satisfy its duty to obtain the best price reasonably available by entering into a merger agreement with a single bidder to establish a floor and then doing a post-signing market check.

The court found it was reasonable for MONY's board to rely on MONY's CEO to negotiate with AXA. The board had decided to explore a sale and had actively supervised the CEO. Given the nature of MONY's business and the risk of losing career agents in a failed auction, the court also found reasonable the board's judgment that the risks of a pre-signing auction, as opposed to a post-signing market check, outweighed the benefits.ⁿ⁴⁶

Vice Chancellor Lamb also found reasonable the board's decision to accept a low-premium transaction. He noted that CSFB--financially incentivized to find the best available price due to a fee of one percent of transaction value--rendered a fairness opinion and was not aware of any entity with an interest in buying MONY at a higher price. Moreover, because AXA and MONY shared the same business model, the career agency system, AXA was a perfect fit, qualified to offer the best price for MONY.

The court found there had been ample time for a competing bidder to emerge and complete its due diligence. To the court, the \$50 million termination fee was "well within the range of reasonableness," representing only 3.3 percent of MONY's equity value and only 2.4 percent of the total transaction value. The court quoted with approval from the 1996 *Kysor* decision, to the effect that commentators "have expressed the view that liquidated damage provisions in the one-to-five percent range of the proposed acquisition price are within a reasonable range."ⁿ⁴⁷

The Delaware Chancery Court's 2005 decision in *In re Toys "R" Us, Inc. Shareholder Litig.* ⁿ⁴⁸ also supports the notion that boards have broad latitude in designing and executing a sale process. After publicly announcing it would explore strategic alternatives for the company, the Toys "R" Us board decided to pursue the sale of the company's most valuable asset, its toy retailing business. During the ensuing auction process, when one of the four competing bidders made an attractive offer for the entire company, the board switched course and solicited entire-company bids from all four bidders. Eventually the board reached an agreement to sell the company to a group led by Kohlberg Kravis Roberts & Co. ("KKR").

Noting that *Revlon* "is not a license for law-trained courts to second-guess reasonable, but debatable, tactical choices that directors have made in good faith," Vice Chancellor Strine rejected the argument that the Toys "R" Us board breached its fiduciary duties by declining to solicit entire-company bids from parties other than the four bidders for the toy business. ⁿ⁴⁹ The Vice Chancellor found that the board's publicly announced search for alternatives gave potential buyers ample notice that the board would entertain offers for the company. The Vice Chancellor also held that the board had not breached its duties by allowing KKR and another of the four bidders to join together to make a "club" bid for the entire company, finding that the board otherwise risked losing a "powerful bidding competitor" to the group that had first proposed an entire-company transaction.ⁿ⁵⁰

The Vice Chancellor found that the deal-protection provisions granted to KKR--which included a 3.75 percent break-up fee and a right to match any competing bid--were reasonable in light of the company's "lengthy search for alternatives, the obvious opportunity that unsolicited bidders had to come forward over the last year, and the large gap" between KKR's bid and that of its nearest competitor.ⁿ⁵¹ The Vice Chancellor was skeptical that the size of the break-up fee or the existence of the matching rights would deter a bidder willing to pay a substantially higher price, noting that topping bids in the face of such provisions "are simply not that unusual."ⁿ⁵²

In three 2007 decisions applying *Revlon* in the context of a sale of a company to a private equity buyer, Vice Chancellor Strine provided further guidance regarding the relationship between the sales process and the package of deal protections built into acquisition agreements. These cases, *In re Netsmart Technologies, Inc. S'holders Litig.*,ⁿ⁵³ *In re Topps Co. S'holders Litig.*ⁿ⁵⁴ and *In re Lear Corp. S'holder Litig.*,ⁿ⁵⁵ reveal an apparent skepticism on the part of Vice Chancellor Strine that management always acts in the best interests of stockholders when private equity comes knocking, given that executives inevitably think about their roles--and compensation--after a deal is done. However,

these cases also demonstrate the continued reluctance of the Delaware Chancery Court to enjoin transactions on the basis of breach of fiduciary duty claims when doing so could deny stockholders the opportunity to consider a proposed transaction, particularly in the absence of a competing bid.

Netsmart Technologies Inc. was a "micro-cap" company, with a market capitalization of around \$100 million and a thinly traded public float. It was not generally known in the market that Netsmart was for sale. After deciding to seek interest from potential buyers, Netsmart's board determined to limit its search to private equity buyers and only then formed a special committee of non-management members of the board. After a limited auction process with several potential private equity buyers, Netsmart entered into a merger agreement with Insight Venture Partners and Bessemer Venture Partners in November 2006. Netsmart's CEO was involved significantly in the negotiation of the merger agreement. Netsmart's board relied on a standard "fiduciary out" clause and a 3% termination fee to allow for a post-signing market check. The buyers rejected a "go-shop" provision proposed by Netsmart.

In contrast, Lear Corporation was a Fortune 200 company with a market capitalization in excess of \$2.5 billion and deep analyst coverage. In 2006, Carl Icahn made a large investment in Lear, and, in part because of Icahn's reputation for takeovers, the market knew that Lear was "in play." Icahn approached Lear's CEO in January 2007 about a going private transaction; a week later, Lear's CEO reported Icahn's overture to the board. A special committee of non-management directors was formed, but Lear's CEO led most of the merger agreement negotiations. Icahn threatened to withdraw his bid if Lear conducted a pre-signing sale process. Lear and Icahn came to terms on a transaction in February 2007, which included a 45-day go-shop period and a two-tier termination fee (2.8% during the go-shop period and 3.5% thereafter). Lear's stockholders ultimately rejected a sweetened version of the proposed deal in July 2007.

Topps also involved a high-profile suitor--Michael Eisner. *Topps*, a company struggling financially and run by the son of one of its founders, had a market cap of less than \$500 million. It was the subject of a proxy fight in 2005, which resulted in the compromise election of three insurgent directors to its board. Eisner approached the *Topps*' CEO to express an interest in being helpful and ultimately in acquiring the company and keeping management in place. The parties negotiated a merger agreement with a 40-day go-shop period, a 3% go-shop termination fee and a 4.6% post-go-shop termination fee. At the last minute, *Topps* was approached by its rival (and frequent suitor) The Upper Deck Company, which expressed interest in making a bid but did not receive any serious response from *Topps*. The *Topps* board eventually held discussions with Upper Deck during the go-shop period, and Upper Deck bid \$1.00 per share more than Eisner. However, the *Topps* board did not treat Upper Deck as a party eligible for the lower break-up fee under the merger agreement, nor would it waive a standstill to allow Upper Deck to make a public competing bid. Both Upper Deck and stockholders of *Topps* brought claims in connection with the proposed Eisner transaction.

It is not uncommon for an interested buyer to contact a potential target's CEO to float the possibility of an acquisition. The Chancery Court was not perturbed that the CEOs received the initial overtures in *Lear* and *Topps*, although Vice Chancellor Strine was critical of Lear's CEO for waiting a full week after Icahn's initial contact before notifying the Lear board. Of greater concern to the court was the fact that, in both cases, the CEO was approached by a buyer who expressed interest in retaining the CEO after closing. Likewise, in *Netsmart*, management was interested in continuing in its current role and having a "second bite at the apple."⁵⁶ Could management, conflicted in this way, be trusted to negotiate on behalf of the company for the highest price reasonably available? And, more generally, would management steer the company towards private equity buyers rather than strategic buyers who were less likely to keep management in place?

In *Lear*, Vice Chancellor Strine found that the CEO-led negotiation process was "far from ideal" and "unnecessarily raises concerns about the integrity and skill of those trying to represent Lear's public investors."⁵⁷ Moreover, Lear's CEO had previously expressed concern to the board about the majority of his wealth's being tied up in Lear stock and retirement benefits; a transaction such as the one Icahn proposed would allow him to cash out his stock and safeguard his retirement benefits. As the court put it, the CEO was in a "fiduciary quandary."⁵⁸ In *Topps*, the court was similarly

concerned about the long-time CEO of Topps favoring a private equity buyer over Topps' main competitor, a strategic player with its own management team, because of his desire to keep his family in charge of Topps.ⁿ⁵⁹

Finally, in *Netsmart*, the court was highly critical of the board's failure to seek out strategic buyers in any meaningful manner and its decision to ride "the private equity wave"ⁿ⁶⁰ because they "desired to continue as executives and they desired more equity."ⁿ⁶¹ The Vice Chancellor was also bothered by the failure of the Netsmart board to form a special committee until after the board decided to focus only on private equity buyers, suggesting that a potentially conflicted management could have influenced that decision. The Vice Chancellor also criticized the "virtually unlimited access" to special committee deliberations given to Netsmart's CEO and chided the special committee for permitting management to drive the due diligence process, which could allow management to give different "body language" to preferred buyers.ⁿ⁶² Ultimately, however, Vice Chancellor Strine did not find that management's role in negotiating the transactions on behalf of the company fatally tainted the process in any of the cases.

In *Netsmart*, *Lear* and *Topps*, the Delaware Chancery Court reiterated the established principle that no single blueprint exists for boards to fulfill their *Revlon* duties. The right sale process depends on the particular facts and circumstances applicable to the target, including the strategic landscape of its industry; its market capitalization, trading volume and volatility; the extent to which the market is aware it is on the block; the results of any recent discussions with potential suitors; the extent to which deal protection provisions are viewed as reasonable; and possible risks of undertaking a process that involves public disclosure or exposure of sensitive information to competitors.ⁿ⁶³ Much also depends on the court's perception of the extent to which deal protection devices will chill competing bids.

For example, Vice Chancellor Strine found the deal protection terms and the contemplated post-signing market check in the Topps transaction to be reasonable. Although the Vice Chancellor said that the 4.3% termination fee was "a bit high in percentage terms," it was explainable because it included Eisner's expenses and because of the relatively small size of the deal.ⁿ⁶⁴ Topps' decision to enter into the merger agreement with Eisner in the face of a rival bid from Upper Deck was a closer call for the court, but the court found that Topps rightfully was suspicious of Upper Deck's sincerity and noted that Upper Deck's bid excluded a "floundering" business line of Topps.ⁿ⁶⁵ In addition, the merger agreement with Eisner provided for a 40-day go-shop period.ⁿ⁶⁶

In *Lear*, the Chancery Court also found that the deal protection terms were reasonable. Vice Chancellor Strine once again placed great weight on the particular facts and circumstances of the company and the transaction: *Lear* was a large company with substantial analyst coverage, the public knew *Lear* was in play, and Icahn made a credible threat that he would withdraw his bid if any pre-signing market check were performed. Notably, the Vice Chancellor gave little weight to the lower termination fee during the go-shop period. The go-shop provision in *Lear* required a competing bidder to reach a definitive agreement during the 45-day period in order to have the lower termination fee apply--which Vice Chancellor Strine considered unlikely.ⁿ⁶⁷

Although in both *Topps* and *Lear* the court found the use of a go-shop to be reasonable, Vice Chancellor Strine made clear that go-shops are not a panacea that can be used in every context in lieu of a pre-signing market check, and that the specific terms of any go-shop provision can make a difference.

In *Netsmart*, the court found a reasonable probability of success for the plaintiff's claims that the board members' failure to seek out strategic buyers was unreasonable and breached their *Revlon* duties. Vice Chancellor Strine criticized the board for relying on only limited contacts with potential strategic buyers over a long period of time.ⁿ⁶⁸ Vice Chancellor Strine also questioned the Netsmart board's "rote assumption" that the terms of the merger agreement would allow for an adequate, post-signing market check.ⁿ⁶⁹ The Netsmart merger agreement included a "fiduciary out" provision allowing the board to consider unsolicited superior proposals, and the Netsmart board had determined that this provision, in light of a termination fee of approximately 3 percent, would allow a sufficient post-signing market check. The court disagreed, largely because Netsmart was a "micro-cap" company, thinly traded and with limited analyst coverage.

Despite Vice Chancellor Strine's criticisms of the processes followed by these target boards, the only *Revlon* claim that resulted in a preliminary injunction related to Topps' failure to release Upper Deck from its standstill agreement. The court believed the Topps board was using the standstill improperly as a way of fending off an undesired acquirer. In *Netsmart*, even though the court determined that the plaintiffs had a reasonable probability of success on the merits, the court declined to issue an injunction. The Vice Chancellor was concerned that the buyer would walk, depriving the stockholders of the ability to decide for themselves once armed with more complete and accurate information. Instead, in each of *Netsmart*, *Lear* and *Topps*, the court ordered supplemental disclosure regarding the defects in the sale process or management's conflicting interests, and allowed the stockholders to decide for themselves.

[4] When Does the Duty to Seek Best Value Not Apply?

In the *Paramount- QVC* case, Paramount and its directors argued that *Revlon* should not apply, since Paramount had not put itself on the block, but was simply seeking to effect a strategic alliance with Viacom that did not involve the break-up of Paramount and that would give the Paramount shareholders a substantial, although mostly non-voting, stake in the equity of the combined business.

The Delaware Supreme Court rejected this argument, noting that one person, the controlling shareholder of Viacom, was to become the controlling shareholder of the combined enterprise. The court distinguished that situation from a stock merger in which control of the combined company would continue to be vested in a "fluid aggregation of unaffiliated stockholders"ⁿ⁷⁰

The Delaware Supreme Court reasoned that the duty to seek the best value should apply whenever "a majority of a corporation's voting shares are acquired by a single person or entity, or by a cohesive group acting together."ⁿ⁷¹ In those circumstances, "there is a significant diminution in the voting power" of the former public shareholders. The new controlling shareholder can deprive the former public shareholders of their continuing interest in the corporation through a cash-out merger or can otherwise alter the long-term strategic vision of the prior board of directors. As a result, the public shareholders "are entitled to receive, and should receive, a control premium and/or protective devices of significant value."ⁿ⁷²

In contrast, no duty to seek best value should arise in a stock-for-stock merger between two companies, if no individual or "cohesive group" will end up with a controlling block of stock after the merger. This rule, which the Delaware Chancery Court first formulated in the *Time-Warner* case, was reinforced by the Delaware Chancery Court in *Paramount*. Three decisions since *Paramount* bear this out.

In *Arnold v. Society for Savings Bancorp, Inc.*,ⁿ⁷³ the Delaware Supreme Court held that there was no need to apply "enhanced scrutiny" in reviewing the action of the directors of an acquired company with respect to a transaction in which the shareholders of a company ("Bancorp") received stock of Bank of Boston ("BOB") in exchange for each Bancorp share. The court noted that there was no sale or change of control when control of the constituent companies remained in a large, fluid, changeable and changing market. Although the plaintiff argued that there had been a change of control in Bancorp because its former stockholders ended up as minority shareholders in the surviving company, thereby losing their opportunity to enjoy a control premium, the court noted that "plaintiff's opportunity to receive a control premium is not foreclosed"ⁿ⁷⁴ in view of the fact that the plaintiff would continue as a stockholder in BOB. The court also found that Bancorp had not initiated an active bidding process.

In a case involving the competing efforts of Burlington Northern, Inc. and Union Pacific Corporation to acquire Santa Fe Pacific Corporation, the Delaware Supreme Court held that Santa Fe's board did not become subject to a duty to obtain the best immediate value reasonably available for shareholders, after Union Pacific had proposed to acquire Santa Fe, by supporting a merger agreement in which Santa Fe stockholders would receive shares of Burlington (following a joint tender offer in which Santa Fe and Burlington would buy up to 33 percent of Santa Fe's stock for

cash, conditioned on the approval of the back-end merger).ⁿ⁷⁵ The court noted that there was no allegation that the Santa Fe board had decided to pursue a transaction that would result in the sale of control of Santa Fe to Burlington. Instead, the board appeared to have been committed to a stock-for-stock merger with Burlington, and there was no allegation that control of the post-merger company would not remain in a "large, fluid, changeable and changing market."ⁿ⁷⁶

However, the Delaware Supreme Court concluded that Union Pacific had stated a triable issue concerning whether certain actions taken by the Santa Fe board--for example, implementing the joint Santa Fe-Burlington tender offer which resulted in Burlington's owning 16 percent of Santa Fe; adopting a poison pill; and applying the poison pill to exempt the Burlington offer but not the Union Pacific offer--were reasonable in relation to the threat posed, under the Delaware Supreme Court's decision in *Unocal*.ⁿ⁷⁷ The court stated: "As the terminology of enhanced judicial scrutiny implies, boards can expect to be required to justify their decision-making, within a range of reasonableness, when they adopt defensive measures with implications for corporate control."ⁿ⁷⁸

A similar decision arose out of the bidding by Wells Fargo & Co. and First Bank System, Inc. for First Interstate Bancorp.ⁿ⁷⁹ After receiving a merger proposal from Wells Fargo, First Interstate entered into a stock-for-stock merger agreement with First Bank, involving shares having a somewhat lower market value than the Wells Fargo proposal. First Interstate also amended its rights plan to make it inapplicable to the First Bank merger. The merger agreement provided for a break-up fee of up to \$100 million if certain triggering events occurred, and for reciprocal options, exercisable if someone else bought 20 percent or more of the optionor. The options were capped so that the total profit to the holder could not exceed \$100 million.

The First Bank merger had a total value of about \$10 billion, so that the cost to First Interstate of backing out of a merger with First Bank would have been about two percent of the transaction value. In litigation brought by Wells Fargo, which had announced its intention to proceed with a hostile exchange offer for First Interstate shares, Delaware's Chancellor Allen concluded that the directors of First Interstate were not under a *Revlon* duty to seek the highest present value reasonably available.

Chancellor Allen said, however, that the fact that *Revlon* did not apply did not mean that the First Interstate directors had no duty, when they rejected the Wells Fargo proposal and entered into the First Bank merger, to proceed advisedly in a good faith attempt to advance the interests of First Interstate. The court accepted the argument that the First Interstate board's actions in entering into the merger agreement with First Bank and refusing to redeem the First Interstate rights with respect to the Wells Fargo offer could be characterized as defensive actions under *Unocal*. First Interstate had argued that, even if so, the directors' acts were reasonable. In passing, the court stated that "[o]ne might well be tempted to agree with the defendants in respect to the break-up fees and stock-options provisions of the merger agreement; the effect of the rights plan, however, is plainly of a different order of magnitude."ⁿ⁸⁰

[5] The Duty to Be Informed About Alternatives in a Negotiated Stock Merger

Even in the context of a stock-for-stock merger not involving a change of control, Delaware law requires directors to act on an informed basis consistent with their ongoing duty of care. Accordingly, Delaware decisions in such cases have questioned the validity of flat "no-talk" covenants prohibiting the target from providing information to or entering into merger discussions with alternative suitors--in part because these no-talk provisions meant the directors were not fully informed.ⁿ⁸¹

In *Ace Ltd. v. Capital Re Corp.*,ⁿ⁸² Ace, which owned 12.3 percent of Capital Re's shares, agreed to acquire the remainder of Capital Re in a stock merger. Ace obtained agreements to vote in favor of the merger from holders of 33.5 percent of Capital Re's shares. The voting agreements terminated only if the merger agreement itself terminated. The merger agreement contained a no-talk clause with a narrow "fiduciary out"--Capital Re could respond to an unsolicited superior proposal by providing information or entering into discussions, but only if its board decided, on the basis of

written advice of counsel, that this were required to prevent the board from breaching its fiduciary duties. If Capital Re complied with these restrictions and was not otherwise in breach of the agreement, gave advance notice to Ace, and paid a \$25 million termination fee, it could terminate the agreement to accept the superior deal.

Ace sought an order restraining Capital Re from terminating the agreement to accept a competing higher bid from XL Capital Ltd. Ace claimed that Capital Re had failed to comply with the no-talk covenant. The Capital Re board had received written advice of counsel that entering into discussions with XL was "consistent with"--rather than required by--the board's fiduciary duties. The lawyer orally advised the directors that if they considered the XL offer to be reasonably likely to result in a superior proposal, it would be appropriate for them to conclude that their fiduciary duties required them to consider XL's offer. The Chancery Court declined to enjoin Capital Re from terminating the agreement.ⁿ⁸³

Vice Chancellor Strine found that the better reading of the no-talk clause was that the board retained the ultimate judgment about whether its fiduciary duties required it to enter into discussions with XL, even if that judgment must be "based" on written advice of counsel. According to the Vice Chancellor, if the no-talk provision in fact prevented Capital Re's board from discussing another offer unless it received an opinion that discussions were required, the provision "comes close to self-disablement by the board" and was likely to be found invalid.ⁿ⁸⁴

Ace argued that, in the case of a stock merger not involving a change of control, the *Revlon* and *QVC* cases would not require a board to talk to other suitors because, in such a case, it would not have a *Revlon* duty to obtain the highest value reasonably available. The court stated that, even if the board has no *Revlon* duties, this "does not mean that it can contractually bind itself to sit idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about."ⁿ⁸⁵

The court considered whether the no-talk covenant, as construed by Ace, constituted an unreasonably preclusive and coercive defensive obstacle under the *Unocal* case, as well as whether the Capital Re board might have violated its duty of care if it agreed to the covenant under the mistaken belief that it retained the ability to consider a superior offer. The court found that, "under either doctrinal rubric, [the no-talk covenant] as construed by Ace is of quite dubious validity."ⁿ⁸⁶

The Vice Chancellor did not question the provisions of the no-talk covenant that prohibited Capital Re from soliciting alternative transactions: "It is one thing for a board of directors to agree not to play footsie with other potential bidders or to stir up an auction. That type of restriction is perfectly understandable, if not necessary, if good faith business transactions are to be encouraged."ⁿ⁸⁷ Further, the court suggested that there may be limited circumstances where a board could prudently place itself in the position of not being able to entertain and consider a superior proposal in these circumstances. The court noted that one such legitimate circumstance may be where a board "has actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end."ⁿ⁸⁸ However, where a board has not explored the market thoroughly and is negotiating a transaction that requires stockholder approval and would result in a change in stockholder ownership interests, "a board's decision to preclude itself--and therefore the stockholders--from entertaining other offers is less justifiable."ⁿ⁸⁹

Moreover, the court put substantial weight on its belief that, if Capital Re were unable to terminate the merger agreement, Capital Re's shareholders would be forced to accept a financially inferior proposal because of Ace's 12.3 percent ownership position and voting agreements with holders of 33.5 percent of Capital Re's shares. The vice chancellor stated that it might be a different matter for the board to agree to put the merger agreement to a vote "if there are no other provisions tied to the agreement that operate to preclude the stockholders from freely voting down the merger and accepting another deal or opting for no deal at all."ⁿ⁹⁰ The court found this was not such a case: "In this context where the board is making a critical decision affecting stockholder ownership and voting rights, it is especially important that the board negotiate with care and retain sufficient flexibility to ensure that the stockholders are not

unfairly coerced into accepting a less than optimal exchange for their shares."⁹¹

In *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,⁹² when Asarco and Cyprus Amax agreed to a stock merger, their agreement contained a flat no-talk covenant, with no fiduciary-duty exception. Phelps Dodge subsequently proposed stock-for-stock mergers with both companies. Asarco and Cyprus Amax declined to talk to Phelps Dodge, citing the no-talk provisions. Phelps Dodge commenced exchange offers for both companies and brought suit challenging the no-talk clause. Phelps Dodge also challenged as excessive the merger agreement's termination fee provisions.

Delaware Chancellor Chandler denied Phelps Dodge's request for a preliminary injunction striking down the provisions, on the ground that there was no showing that irreparable injury would result from not issuing the injunction: if the shareholders of Asarco and Cyprus Amax wanted their companies to consider the Phelps Dodge proposal, they could vote at the shareholder meetings to reject the Asarco-Cyprus Amax merger agreement.⁹³

The Chancellor held, however, that Phelps Dodge had shown a reasonable probability of success on the merits. Although, under Delaware case law, directors in a transaction not involving a change of control are not required to negotiate with a competing bidder, the decision not to negotiate "must be an informed one."⁹⁴ The *Phelps Dodge* court found no-talk provisions to be "troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party."⁹⁵ The directors should not have completely foreclosed the opportunity to negotiate with a third party, "as this is the legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care; that is, the duty to take care to be informed of all material information reasonably available."⁹⁶

In light of its decision concerning the duty of care, the *Phelps Dodge* court did not reach the question whether the merging companies' deterrents against competing bids were, under the *Unocal* case, unreasonable responses to a threat to corporate policy. The court did say, however, that the termination fee, which amounted to 6.3 percent of the equity value of the transaction for Asarco, certainly seemed to "stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point."⁹⁷

These cases show that the validity of no-talk covenants will very much depend on the facts and circumstances surrounding their negotiation. These two decisions do not suggest that no-talk provisions are necessarily invalid--a view that was reinforced in a Chancery Court decision handed down shortly after *Ace*, in which Vice Chancellor Steele noted that no-talk provisions "are common in merger agreements and do not imply some automatic breach of fiduciary duty."⁹⁸ However, the *Ace* and *Phelps Dodge* decisions make clear that in a stock merger not involving a sale of control:

... while companies may flatly agree not to solicit competing bids, limitations on a board's ability to enter into discussions or provide information may not be so strict as to prevent the board from exercising its fiduciary duties; and

... while directors may decide not to negotiate with another company, that decision should be an informed one.

[6] Transactions Involving Controlling Shareholders

In *McMullin v. Beran*,⁹⁹ the Delaware Supreme Court addressed the issue of whether the *Revlon* duty to maximize shareholder value in change of control transactions applies to situations where control of the company rests with a single shareholder, rather than with the public. *McMullin* arose out of a 1998 proposal by Lyondell Petrochemical Company to buy ARCO Chemical Company ("Chemical") in a cash tender offer and second-step cash merger. At the time of the tender offer, Atlantic Richfield Company ("ARCO") owned approximately 80 percent of Chemical's

common stock. The Lyondell proposal contemplated a tender offer to purchase all outstanding shares of Chemical for \$57.75 per share, a commitment from ARCO to tender all of its shares at the same price, and a second-step merger whereby all untendered shares would be cashed out at the same time. The transaction was unanimously approved by Chemical's board.

The plaintiff argued, among other things, that Chemical's board had breached its fiduciary duties under *Revlon* and had abdicated its fiduciary responsibilities by leaving it to the minority shareholders to determine how to vote on the merger proposal. The Delaware Chancery Court rejected both arguments. With respect to the first argument, the Chancery Court reasoned that, because in such a case public shareholders never have a right to a control premium in the first place, there "could not be a change of control costing them the opportunity to participate in a change of control premium."¹⁰⁰ Thus, the court concluded, it would be inappropriate to extend the *Revlon* duties to such cases. With respect to the second argument, the court concluded that, because the minority shareholders were powerless to prevent the proposed merger, it did not matter how they voted on the acquisition proposal and, therefore, it would have been fruitless for Chemical's board to try to influence their decision. Therefore, the board had no duty to take a more active role in that process.¹⁰¹

The Delaware Supreme Court reversed, noting that, while the public shareholders could not defeat a transaction proposed by the majority shareholder, they still had a choice between accepting the price offered or seeking appraisal of their shares.¹⁰² In making this decision, the public shareholders were entitled to look to the board for guidance as to whether the transaction maximized value for all shareholders.¹⁰³ Therefore, the court concluded that while, in these circumstances,

"the board cannot realistically *seek* any alternative because the majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board's consideration, [n]evertheless, in such situations, the directors are obliged to make an informed and deliberate judgment, in good faith, about whether the sale to a third party that is being proposed by the majority shareholder will result in a maximization of value for the minority shareholders."¹⁰⁴

The court found that there were triable issues as to whether the Chemical directors had breached their duties of care and loyalty: care, in light of allegations that the Chemical directors met only once to consider the transaction and had not adequately informed themselves whether the consideration was at least equal to the appraisal value of Chemical; loyalty, in that a majority of the directors were affiliated with ARCO and had not abstained from the discussions or vote on the transaction.¹⁰⁵

In contrast, in *In re CompuCom Systems, Inc. S'holders Litig.*,¹⁰⁶ the Delaware Chancery Court held that a minority shareholder suing the board of CompuCom for allegedly selling the company at a "fire sale price" at the behest of the company's controlling shareholder failed to overcome the presumption of the business judgment rule that the board acted in good faith and on an informed basis--even though the merger price per share was less than the stock's market price on the day before the announcement of the transaction. The court rejected the plaintiff's claim that the board improperly allowed the controlling shareholder of CompuCom to unload the company at an inadequate price to satisfy "its pressing need for cash."¹⁰⁷

On May 28, 2004, CompuCom announced that it would merge with Platinum Equity Capital Partners L.P. Under the terms of the merger agreement, Platinum would buy CompuCom for \$254 million, or \$4.60 per share. The day before the transaction was announced, CompuCom's stock was trading at \$4.84 per share. The controlling shareholder of CompuCom, Safeguard Scientifics Inc., would receive about \$128 million in the sale.

A CompuCom shareholder, Central Laborer's Pension Fund, brought a class action against the CompuCom board, alleging that the board breached its *Revlon* duty to obtain the best price for the company. The plaintiff claimed that the motivation for the sale was that Safeguard and its founder and CEO, Warren V. Musser, had a "pressing need" for cash

after losing millions on risky Internet and technology stocks. According to the plaintiff, when those stocks crashed, Musser was in "dire straits" and owed \$26.5 million to Safeguard for covering his margin loans. Musser also owned a significant stake in CompuCom, and a quick sale of the company would generate cash to repay Safeguard. The complaint alleged that the defendant directors were dominated and controlled by the majority shareholder when they sold the company to Platinum and that they improperly agreed to sell the company in a "fire sale" for an inadequate price in order to satisfy the majority shareholder's need for cash.¹⁰⁸

The plaintiff cited *McMullin* as controlling precedent. However, Vice Chancellor Lamb distinguished the facts of this case from those in *McMullin*, concluding that, "[u]nlike *McMullin*, the complaint itself reveal[ed] that the board of CompuCom undertook its fiduciary duty of care with all the seriousness and diligence that was required."¹⁰⁹ The Vice Chancellor noted with approval that the board had formed a special committee of outside directors to negotiate the sale with Platinum and that the special committee evaluated indications of interest received from potential acquirors, reviewed the company's strategic alternatives, negotiated the deal with Platinum and made recommendations to the full board. All of this was done with the assistance of independently selected legal and financial advisors and in reasonable reliance on the financial advisors' opinions to the effect that the \$4.60 per share cash consideration was fair to the CompuCom public stockholders. The court noted also that the CompuCom board "did not hastily approve a transaction about which it was not fully informed."¹¹⁰ Unlike in *McMullin*, where the board met once to consider the transaction, the sale of CompuCom was the result of a multi-year process in which the special committee explored various strategic alternatives to maximize stockholder value.¹¹¹

Accordingly, the court rejected the plaintiff's claim that the board had "orchestrated a 'fire sale' and rashly sold CompuCom for a discounted price."¹¹² Nor would the court "infer that the price of the challenged merger was so inadequate as to overcome the business judgment rule."¹¹³ Vice Chancellor Lamb pointed out that it was not enough for the plaintiff to argue that the financial press objected to the adequacy of the merger price or that the final price was below the market price. Moreover, the court noted that, "if the plaintiff was dissatisfied with the price, it could have exercised its appraisal remedy."¹¹⁴

[7] States Other Than Delaware

As stated at the outset of this chapter, while more public companies are incorporated in Delaware than anywhere else, advisers to target company directors should bear in mind that laws of other states may differ significantly from that of Delaware. Not all states would apply the Delaware case law in requiring enhanced scrutiny of decisions to sell the company, beyond the usual business judgment tests. It is also worth noting that the law on directors' duties in change of control situations is simply not as well developed in other states as it is in Delaware and that such other states' courts may or may not follow Delaware's lead when they are faced with similar issues for the first time.

For example, in reviewing (under New York law) a decision of a target company to go with one bidder rather than another, a federal district court noted that the New York courts had not adopted *Paramount- QVC* and *Revlon* and that, under New York's business judgment rule, a court would not overturn an informed decision of directors absent some showing of fraud, illegality or self-dealing.¹¹⁵

Similarly, a North Carolina state court declined to apply *Revlon* to strike down a stock option provision that resulted in a \$780 million break-up fee in a merger agreement between Wachovia Corp. and First Union Corp.¹¹⁶ Although the court looked in part to Delaware case law for guidance, it noted that under the North Carolina statute, "the duties of a director weighing a change of control situation shall not be any different, nor the standard of care any higher, than otherwise provided in this section."¹¹⁷ The court interpreted this provision as intended "to eliminate by statute the unidimensional requirement imposed on directors by *Revlon*."¹¹⁸ The court concluded that the provision in question "evidenced a policy that obtaining the highest dollar value for the shareholders was not the *sole* criteria by which the courts could or should judge the conduct of directors in change of control situations."¹¹⁹ In addition, the court noted that, "[t]o the extent *Revlon* could be read to require a higher level of attentiveness from directors in change of control

situations than in other situations, the [statute] eliminated that requirement as well."n120

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities Fiduciary Responsibilities

FOOTNOTES:

(n1)Footnote 1. *Revlon, Inc. v. MacAndrews & Forbes, Inc.*, 506 A.2d 173 (Del. 1985) .

(n2)Footnote 2. *Revlon*, 506 A.2d at 182 .

(n3)Footnote 3. *Revlon*, 506 A.2d at 182 .

(n4)Footnote 4. *Revlon*, 506 A.2d at 182 .

(n5)Footnote 5. *Revlon*, 506 A.2d at 182 .

(n6)Footnote 6. *Revlon*, 506 A.2d at 184 .

(n7)Footnote 7. *Revlon*, 506 A.2d at 184 .

(n8)Footnote 8. *Revlon*, 506 A.2d at 180 (citing *Unocal*, 493 A.2d at 955) .

(n9)Footnote 9. *Revlon*, 506 A.2d at 182 .

(n10)Footnote 10. *Revlon*, 506 A.2d at 184 .

(n11)Footnote 11. *Paramount Communications Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) .

(n12)Footnote 12. *Paramount-Time*, 571 A.2d at 1150 .

(n13)Footnote 13. *Paramount-Time*, 571 A.2d at 1150 . See also *Lyondell Chemical Co. v. Ryan*, C.A. No. 401, 2008, slip. op. at 14 (Del. Mar. 25, 2009) ("*Revlon* duties do not arise simply because a company is 'in play.' The duty to seek the best available price applies only when a company embarks on a transaction--on its own initiative or in response to an unsolicited offer--that will result in a change of control.")

(n14)Footnote 14. *Paramount-Time*, 571 A.2d at 1150 .

(n15)Footnote 15. *Paramount-Time*, 571 A.2d at 1152 .

(n16)Footnote 16. *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994) .

(n17)Footnote 17. *Paramount-QVC*, 637 A.2d at 39-41 .

(n18)Footnote 18. *Paramount-QVC*, 637 A.2d at 48 .

(n19)Footnote 19. *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34, 44 (Del. 1994) .

(n20)Footnote 20. *Paramount-QVC*, 637 A.2d at 45 .

(n21)Footnote 21. *Paramount-QVC*, 637 A.2d at 45 (emphasis in original). Chancellor Allen, in his decision on remand in *Cede & Co. v. Technicolor*, 663 A.2d 1134, 1143 (Del. Ch. 1994) made a related point: As to price, at least

in the non-self-dealing context, a fair price does not mean the highest price financeable; "it means a price that is one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept." The Delaware Supreme Court, in affirming Chancellor Allen's decision that the sale in question satisfied the test of entire fairness, stated that "a finding of perfection is not a *sine qua non* in an entire fairness analysis." *Cinerama Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1179 (Del. 1995) . The court reviewed both components of fairness, fair dealing and fair price, noting among other things evidence of vigorous arm's-length negotiation and an increase in the offered price; the ability of the target company to furnish information to competing bidders and to terminate the merger agreement with the first bidder if a merger was not completed by a specified drop-dead date; the fact that more than 75 percent of the shares of the target company had been tendered; the size of the premium involved; the willingness of large stockholders on the board to sell to the bidder at the transaction price; and the fact that no rival bidder came forward even though the transaction did not close for several months after it had been announced. *Cinerama*, 663 A.2d at 1172-1180 .

(n22)Footnote 22. *Paramount-QVC*, 637 A.2d at 44 .

(n23)Footnote 23. *Paramount-QVC*, 637 A.2d at 44 & n.14. In its November meeting, the only advice the Paramount board had received that purported to quantify the incremental long-term benefits of the Viacom transaction over those of the QVC transaction came from a management consulting firm, not from an investment banker.

(n24)Footnote 24. *Paramount-QVC*, 637 A.2d at 44 .

(n25)Footnote 25. *Paramount-QVC*, 637 A.2d at 48-49 .

(n26)Footnote 26. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (1989) .

(n27)Footnote 27. *Mills*, 559 A.2d at 1286 .

(n28)Footnote 28. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279 (Del. 1989) . See also *In re Fort Howard Corp. S'holders Litig.*, C.A. 9991, 1988 Del. Ch. LEXIS 110 (Aug. 8, 1988) , appeal refused 547 A.2d 633 (Del. 1988) .

(n29)Footnote 29. *Barkan*, 567 A.2d at 1286 (citing *Revlon*, 506 A.2d at 182-85) .

(n30)Footnote 30. *Barkan*, 567 A.2d at 1286 (citing *In re Fort Howard Corp. S'holders Litig.*, C.A. 9991, 1988 Del. Ch. LEXIS 110 (Aug. 8, 1988)).

(n31)Footnote 31. *Barkan*, 567 A.2d at 1287 .

(n32)Footnote 32. *Barkan*, 567 A.2d at 1288 .

(n33)Footnote 33. *Barkan*, 567 A.2d at 1288 . See § 12.05[3], *infra*, for a discussion of the Delaware Chancery Court's decisions in *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007) , *In re Topps Co. S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007) and *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007) , analyzing the relationship between the sales process and deal protections in the context of a sale of a company to a private equity buyer.

(n34)Footnote 34. *Barkan*, 567 A.2d at 1288 .

(n35)Footnote 35. *In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691 (Del. Ch. 2001) .

(n36)Footnote 36. *Pennaco*, 787 A.2d at 705 .

(n37)Footnote 37. *Pennaco*, 787 A.2d at 705 .

(n38)Footnote 38. *Pennaco*, 787 A.2d at 706 .

(n39)Footnote 39. *Pennaco*, 787 A.2d at 706 (citing *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1287 (Del. 1989)) . See also *McMichael v. U.S. Filter Corp.*, C.A. No. EDCV 99-182, 2001 U.S. Dist. LEXIS 3918 (C.D. Cal. Feb. 23, 2001) , in which a U.S. District Court held, under Delaware law, that *Revlon* did not require an auction in every case, and that a transaction with one bidder could be approved if the directors possessed a body of reliable evidence with which to evaluate the fairness of the transaction. In *McMichael*, the target company's directors spent almost two years negotiating the transaction, conducting "due diligence," approving possible merger partners, and retaining investment banks to conduct market checks and issue fairness opinions. These circumstances supported a finding that the directors exercised the requisite due care. *McMichael*, 2001 U.S. Dist. LEXIS 3918, at *41 (citing *Barkan*, 567 A.2d at 1287).

(n40)Footnote 40. *Pennaco*, 787 A.2d at 705 .

(n41)Footnote 41. *Pennaco*, 787 A.2d at 707 .

(n42)Footnote 42. *Pennaco*, 787 A.2d at 707 .

(n43)Footnote 43. *In re MONY Group Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004) .

(n44)Footnote 44. The court, however, granted a preliminary injunction based on claims that the merger proxy statement did not disclose all material information in the board's possession. Specifically, the court found the proxy statement to be misleading because, although it emphasized the fact that MONY negotiated reduced payments to be made to management under their change in control agreements in order to obtain a better price for the shareholders, it failed to disclose information the board had about the size of change in control payments in comparable transactions in the financial services industry. The court found that the omitted information would have revealed that the change in control payments in question were "considerably more lucrative than normal." *MONY*, 852 A.2d 9 at 21 .

(n45)Footnote 45. *MONY*, 852 A.2d at 28, n.31 (quoting the window shop provision).

(n46)Footnote 46. The court noted that the MONY board was concerned that, in addition to having the typical adverse consequences of a failed auction process on the company and its business, including the resulting negative effect on the market performance of its stock, an auction or active solicitation would allow competitors to use the process to obtain due diligence from MONY and gain access to the company's career agency force. *MONY*, 852 A.2d 9, at 21 .

(n47)Footnote 47. *MONY*, 852 A.2d at 29, n.35 .

(n48)Footnote 48. 877 A.2d 975 (Del. Ch. 2005) .

(n49)Footnote 49. *Toys "R" Us*, 877 A.2d at 1021.

(n50)Footnote 50. *Toys "R" Us*, 877 A.2d at 1009 .

(n51)Footnote 51. *Toys "R" Us*, 877 A.2d at 1018 .

(n52)Footnote 52. *Toys "R" Us*, 877 A.2d at 1019 .

(n53)Footnote 53. 924 A.2d 171 (Del. Ch. 2007) .

(n54)Footnote 54. 926 A.2d 58 (Del. Ch. 2007) .

(n55)Footnote 55. 926 A.2d 94 (Del. Ch. 2007) .

(n56)Footnote 56. *Netsmart*, 924 A.2d at 181 .

(n57)Footnote 57. *Lear*, 926 A.2d at 118.

(n58)Footnote 58. *Lear*, 926 A.2d at 116.

(n59)Footnote 59. *Topps*, 926 A.2d at 81.

(n60)Footnote 60. *Netsmart*, 924 A.2d at 180 .

(n61)Footnote 61. *Netsmart*, 924 A.2d at 198 . In contrast, in *Guttman v. McGinnis*, C.A. No. 3450-VCL (Del. Ch. Jan. 18, 2008), plaintiff shareholders sought to enjoin a cash acquisition of Respironics Inc. by Royal Philips Electronics NV on the grounds that the sale process was flawed because, among other things, the Respironics board focused only on strategic buyers and failed to approach any private equity buyers. In denying the plaintiffs' motion to expedite, Vice Chancellor Lamb pointed out that "[d]ealing exclusively with strategic buyers assuages, rather than heightens, concerns about managers' conflicts of interest" that may be present in private equity deals. *Guttman*, C.A. No. 3450-VCL, Transcript of Oral Argument via *Telephone*, at 26 (Del. Ch. Jan. 18, 2008).

(n62)Footnote 62. *Netsmart*, 924 A.2d at 193-94 .

(n63)Footnote 63. *See also* *Lyondell Chemical Co. v. Ryan*, C.A. No. 401, 2008, slip. op. at 16 (Del. Mar. 25, 2009) ("No court can tell directors exactly how to accomplish [the goal of obtaining the best available price for the stockholders], because they will be facing a unique combination of circumstances, many of which will be outside their control.").

(n64)Footnote 64. *Topps*, 926 A.2d at 86.

(n65)Footnote 65. *Topps*, 926 A.2d at 87.

(n66)Footnote 66. *Topps*, 926 A.2d at 86.

(n67)Footnote 67. *Lear*, 926 A.2d at 121. The merger agreement in *Lear* was subsequently amended to provide for a \$25 million termination fee payable to Icahn if Lear's stockholders voted down the merger, in exchange for an increase in the merger price from \$36 to \$37.25 per share. In *In re Lear Corp. S'holder Litig.*, Cons. C.A. No. 2728, 2008 WL 4053221 (Del. Ch. Sept. 2, 2008), Vice Chancellor Strine held that the board did not act in bad faith in approving the amendment.

(n68)Footnote 68. *Netsmart*, 924 A.2d at 197 .

(n69)Footnote 69. *Netsmart*, 924 A.2d at 177 .

(n70)Footnote 70. *Paramount-QVC*, 637 A.2d at 46 .

(n71)Footnote 71. *Paramount-QVC*, 637 A.2d at 42 (emphasis added).

(n72)Footnote 72. *Paramount-QVC*, 637 A.2d at 42-43 . Such protective devices could include supermajority voting provisions or a requirement that a future merger or other significant transaction be approved by a majority of the minority public shareholders. *Paramount-QVC*, 637 A.2d at 43 n.12 .

(n73)Footnote 73. *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994) .

(n74)Footnote 74. *Arnold*, 650 A.2d at 1290 .

(n75)Footnote 75. *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59 (Del. 1996) .

(n76)Footnote 76. *Santa Fe*, 669 A.2d at 71 . *But cf. In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 732 n.25 (Del. Ch. 1999) (distinguishing *Santa Fe* and concluding that a transaction under which over 30 percent of the merger consideration is shares of common stock of a bidder that is a widely held company with no controlling shareholder (the balance of the consideration being cash) does constitute a change of corporate control, and therefore, *Revlon* is applicable to such a transaction).

(n77)Footnote 77. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 496 (Del. 1985) .

(n78)Footnote 78. *Santa Fe*, 669 A.2d at 72 .

(n79)Footnote 79. *Wells Fargo & Co. v. First Interstate Bancorp.*, C.A. No. 14696, 1996 Del. Ch. LEXIS 3, at *19 (Del. Ch. Jan 18, 1996) .

(n80)Footnote 80. *Wells Fargo & Co. v. First Interstate Bancorp.*, C.A. 14696, 1996 Del. Ch. LEXIS 3, at *19 (Del. Ch. Jan. 18, 1996) .

(n81)Footnote 81. *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999) ; *Phelps Dodge v. Cyprus Amax Minerals Co.*, C.A. 17398, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999) . *Cf.* *Energy Partners, Ltd. v. Stone Energy Corp.*, C.A. 2402-N (Del. Ch. 11, 2006) (declining to construe a merger agreement prohibition on actions impairing the parties' ability to consummate the merger as a "no talk" clause.

(n82)Footnote 82. 747 A.2d 95 (Del. Ch. 1999) .

(n83)Footnote 83. *Ace Ltd.*, 747 A.2d 95 .

(n84)Footnote 84. *Ace Ltd.*, 747 A.2d at 107 .

(n85)Footnote 85. *Ace Ltd.*, 747 A.2d at 108 .

(n86)Footnote 86. *Ace Ltd.*, 747 A.2d at 109 .

(n87)Footnote 87. *Ace Ltd.*, 747 A.2d at 107 .

(n88)Footnote 88. *Ace Ltd.*, 747 A.2d at 107 n.36 .

(n89)Footnote 89. *Ace Ltd.*, 747 A.2d at 107 n.36 . On the validity of transaction lock-up provisions, *see also Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) (a merger agreement that required that the merger be put to a stockholder vote even if the target board no longer recommended approval of the merger, without a fiduciary out and coupled with an agreement of stockholders with a majority of the voting power to vote in favor of the merger, was invalid even though it was preceded by an auction). *Cf. Orman v. Cullman*, C.A. No. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004) (upholding a voting agreement by a controlling stockholder that precluded consummation of a competing transaction for 18 months after termination of the merger agreement with the first bidder); *Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (upholding a merger agreement that permitted the acquirer to terminate the agreement if target shareholder approval of the merger was not obtained within 24 hours after the merger agreement was signed).

(n90)Footnote 90. *Ace Ltd.*, 747 A.2d at 107 n.34 .

(n91)Footnote 91. *Ace Ltd.*, 747 A.2d at 109 .

(n92)Footnote 92. *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, CA 17398, 1999 Del. Ch. LEXIS 202 (Sept. 27, 1999) .

(n93)Footnote 93. *Phelps Dodge, 1999 Del. Ch. LEXIS 202* .

(n94)Footnote 94. *Phelps Dodge, 1999 Del. Ch. LEXIS 202, at *3-4* .

(n95)Footnote 95. *Phelps Dodge, 1999 Del. Ch. LEXIS 202, at *4* .

(n96)Footnote 96. *Phelps Dodge, 1999 Del. Ch. LEXIS 202, at *4-5* .

(n97)Footnote 97. *Phelps Dodge, 1999 Del. Ch. LEXIS 202, at *5* .

(n98)Footnote 98. *In re IXC Communications, Inc. S'holders Litig., C.A. 17334, 1999 Del. Ch. LEXIS 210, at *17 (Del. Ch. Oct. 27, 1999)* . See also *State of Wis. Inv. Bd. v. Bartlett, C.A. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000)* (holding that a board does not breach its duty of loyalty by agreeing to include termination fee and no-talk provisions in a merger agreement, if the board thoroughly canvasses the market prior to entering into the merger agreement and if there is no competing bid from a third party).

(n99)Footnote 99. *McMullin v. Beran, 765 A.2d 910 (Del. 2000)* .

(n100)Footnote 100. *McMullin v. Beran, C.A. 16493, 1999 Del. Ch. LEXIS 227, at *11 (Del. Ch. Dec. 1, 1999)* .

(n101)Footnote 101. *McMullin, 1999 Del. Ch. LEXIS 227, at *11* .

(n102)Footnote 102. *McMullin v. Beran, 765 A.2d 910, 925 (Del. 2000)* .

(n103)Footnote 103. *McMullin, 765 A.2d at 914* .

(n104)Footnote 104. *McMullin, 765 A.2d at 919* (citations omitted).

(n105)Footnote 105. See also *Tooley v. AXA Fin., Inc., (Del. Ch. May 13, 2005)* (holding that, by agreeing to delay the closing of a merger for the benefit of the target's controlling shareholder, the target's board might have violated the minority shareholders' "right to be treated fairly by the board," and that, "to the extent plaintiffs allege that one stockholder was improperly benefited at the expense of another, the plaintiffs may pursue that claim"). Cf. *In re Digex, Inc. S'holders Litig., 789 A.2d 1176 (Del. Ch. 2000)* , in which the Delaware Chancery Court held that *Revlon* does not apply to transactions that involve no change of control of a company in which the public has only a minority interest, but are intended merely to change the ownership of the majority shareholder. The court also pointed out that "it is important to recognize that any effort to sell [a company controlled by a single shareholder] in a *Revlon*-style auction would appear to be futile," because the controlling shareholder has the power to block proposed transactions. *Digex, 789 A.2d at 1196* (citing *McMullin v. Beran, 765 A.2d 910 (2000)*) .

(n106)Footnote 106. *In re CompuCom Sys. S'holders Litig. C.A. No. 499-N, 2005 Del. Ch. LEXIS (Del. Ch. Sept. 29, 2005)*.

(n107)Footnote 107. *CompuCom, 2005 Del. Ch. LEXIS at *21* .

(n108)Footnote 108. *CompuCom, 2005 Del. Ch. LEXIS at *2-7* .

(n109)Footnote 109. *CompuCom, 2005 Del. Ch. LEXIS at *25* .

(n110)Footnote 110. *CompuCom, 2005 Del. Ch. LEXIS at *25-26* .

(n111)Footnote 111. *CompuCom, 2005 Del. Ch. LEXIS at *26-27* .

(n112)Footnote 112. *CompuCom, 2005 Del. Ch. LEXIS at *27* .

(n113)Footnote 113. *CompuCom, 2005 Del. Ch. LEXIS at *28* .

(n114)Footnote 114. *CompuCom, 2005 Del. Ch. LEXIS at *28* .

(n115)Footnote 115. *Minzer v. Keegan, No. CV-97-4077, 1997 U.S. Dist. LEXIS 16445, at *30-32 (E.D.N.Y. Sept. 22, 1997) , aff'd, 218 F.3d 144 (2d Cir. 2000)* .

(n116)Footnote 116. *First Union Corp. v. Suntrust Banks, Inc., Consol. C.A. No. 01-CVS-10075, 2001 NCBC LEXIS 7 (N.C. Sup. Ct. Aug. 10, 2001)* .

(n117)Footnote 117. *2001 NCBC LEXIS 7, at *73* . *N.C. Gen. Stat. § 55-8-30(d)* generally provides that a director is not liable for any action taken, or failure to act, if the director performed the duties "(1) ... in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation."

(n118)Footnote 118. *First Union Corp., 2001 NCBC LEXIS 7, at *72* .

(n119)Footnote 119. *First Union Corp., 2001 NCBC LEXIS 7, at *72* .

(n120)Footnote 120. *First Union Corp., 2001 NCBC LEXIS 7, at *73* .



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Corporate Governance: Law and Practice

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.06

AUTHOR: Meredith M. Brown William D. Regner Meredith Brown is a retired partner and William Regner is a partner in the Mergers and Acquisitions Group of Debevoise & Plimpton LLP. Portions of this Chapter 12 have been adapted from materials used by the authors and their colleagues in other publications, including the book *Takeovers: A Strategic Guide to Mergers and Acquisitions* (Brown, et al.), © Aspen Publishers 2008, and may be contained in other publications by the authors and their colleagues. The authors gratefully acknowledge the assistance of their colleague Dmitriy A. Tartakovskiy in the updating of this chapter.

§ 12.06 Actions That Thwart a Shareholder Vote

One of the reasons courts defer to directors' business decisions is their recognition that the shareholders have elected the directors and have the power to remove them if they disapprove of their decisions. By the same token, courts tend to be critical of defensive actions that work to limit the shareholders' ability to remove directors.

In *Blasius Industries, Inc. v. Atlas Corp.*,ⁿ¹ the Delaware Chancery Court held that if a board acts "for the sole or primary purpose of thwarting a shareholder vote," the board is not entitled to the protection of the business judgment rule, unless it can overcome "the heavy burden of demonstrating a compelling justification for such action."ⁿ²

In the *Blasius* case, Blasius commenced a consent solicitation to increase the number of directors of Atlas from 7 to 15 (the maximum permitted under Atlas's charter) and to elect 8 named persons to fill the vacancies. The board of Atlas held an emergency directors' meeting to amend the bylaws to increase the number of directors from 7 to 9 and to appoint two persons to fill the new vacancies. In so doing, they knew they were precluding the holders of a majority of the company's stock from placing a majority of the new directors on the board through the consent solicitation, if the shareholders wished to do so.

In *MM Companies Inc. v. Liquid Audio Inc.*,ⁿ³ the Delaware Supreme Court held that in cases involving a hostile contest for corporate control, the *Blasius* "compelling justification" test is not an independent standard of judicial review, but rather an extension of the *Unocal* analysis to cases where a defensive measure interferes with the shareholder franchise.

In *Liquid Audio*, as the first stage of its takeover plan, the plaintiff MM nominated candidates for two board seats that were up for election on Liquid Audio's five member board of directors. When it became clear that MM's nominees would be elected, the board of Liquid Audio increased its size from five to seven members and appointed two directors

to fill the new seats. Because Liquid Audio had a staggered board and only one or two directors were up for election in any year, the expansion of the board guaranteed that the incumbent directors would retain control of the board for at least two years. MM sued Liquid Audio and its directors, claiming that the addition of the new directors interfered with the ability of MM's candidates, once elected, to gain a substantial presence on Liquid Audio's board. On appeal from a decision of the Delaware Chancery Court, the Delaware Supreme Court found the board action invalid.

The court explained that the *Blasius* and *Unocal* standards are not mutually exclusive.ⁿ⁴ Rather, the "compelling justification" test of *Blasius* must be applied within the *Unocal* reasonableness standard where the primary purpose of a board's action, taken as a defensive measure, is to "interfere with or impede the effective exercise of the shareholder franchise in a contested election of directors."ⁿ⁵ The court indicated that while the *Unocal* requirement of proportionality applies in such cases, "the special import of protecting the shareholders' franchise within *Unocal*'s requirement" mandates the initial application of the compelling justification test of *Blasius* before applying the more general reasonableness test of *Unocal*.ⁿ⁶

The *Blasius* standard does not apply to the adoption of a notice bylaw that merely defers a shareholder vote, giving directors a limited period of time within which to explore alternatives to a takeover proposal. In *Kidsco, Inc. v. Dinsmore*,ⁿ⁷ the Delaware Chancery Court upheld the adoption by a target company of an amendment to a bylaw to extend the time within which a special meeting called by shareholders had to be held. After The Learning Company ("TLC") had entered into a stock merger agreement with Broderbund Software, Inc., a competing bidder, Softkey International Inc., launched a tender offer for TLC shares conditioned on rejection of the Broderbund transaction, and also announced its intention to call a special meeting of TLC shareholders under a bylaw permitting holders of 10 percent of TLC shares to call a special meeting. The bylaw contemplated that the special meeting had to be held not less than 35 days nor more than 60 days after receipt of the request. The directors extended the period of time from 60 days to 90 days, giving them an additional 25 days to look for alternatives to the Softkey bid. The Chancery Court said that the amendment was not a disenfranchisement under *Blasius*, because shareholders would be permitted to vote, and the amendment merely delayed the vote by 25 days.

Similarly, in *Aquila, Inc. v. Quanta Services, Inc.*,ⁿ⁸ the Chancery Court applied the more lenient *Unocal* test to a management attempt to issue shares likely to be voted for management and against an insurgent stockholder as a defensive measure in a proxy contest, on the basis that such issuances would only make it more difficult, and not impossible, for the insurgent stockholder to win the proxy contest. In this case, Aquila owned approximately 30 percent of Quanta's stock and sought to increase its interest in Quanta by buying shares on the open market and directly from Quanta officers and directors. When Aquila's ownership reached 38.5 percent of Quanta voting power, Quanta amended its poison pill so that it would be triggered if Aquila's ownership exceeded 39 percent.

Aquila responded by announcing its intention to nominate an opposing slate of directors at Quanta's annual meeting. Quanta then formed a special committee of non-Aquila directors to "maximize [the] odds" of winning the proxy contest. The committee approved the creation of a Stock Employee Compensation Trust ("SECT"), whereby Quanta issued 8 million of its shares--about 10 percent of the outstanding shares--to the SECT for use in Quanta's employee compensation plans. Shares in the trust that had not yet been allocated to employee benefit plans were to be voted in accordance with instructions from Quanta employees participating in the company's employee stock plan--increasing the proportional voting power of Quanta employees at the expense of other shareholders and diluting Aquila's voting power 10 percent from 38 percent to 34 percent. Aquila sued Quanta for an injunction against voting the SECT shares.ⁿ⁹

The court found that the director defendants' authorization of the SECT was a defensive measure taken in the context of a proxy fight and other takeover related activity, but nevertheless concluded that the terms of the SECT, including its voting mechanic, were neither preclusive nor coercive. The 10 percent dilution only made it more difficult, but not impossible, for Aquila to win the proxy contest and, thus, more likely, but far from certain, that the members of the special committee would be reelected as directors.ⁿ¹⁰

Although Vice Chancellor Lamb noted that Delaware courts "are particularly vigilant in protecting against 'legal strategies ... to frustrate ... a shareholder vote,'"n11 he refused to apply the strict "compelling justification" test set out in *Blasius* to the actions of the special committee and examined them under the general *Unocal* and *Unitrin* standards.n12 Under those standards, the Vice Chancellor found that there was no or little relationship between the particular mechanism for voting the SECT shares and a threat of employee instability on which the special committee claimed to have relied in adopting the SECT. Therefore, there was a "reasonable probability" that the adoption of the SECT, with its dilutive voting provisions, was not a permissible defensive measure under the *Unocal* and *Unitrin* standards and that the SECT voting mechanism was "illegally dilutive."n13

In *Mercier v. Inter-Tel (Delaware) Inc.*,n14 the Delaware Chancery Court held that a special committee of Inter-Tel's board did not breach its fiduciary duties by postponing a shareholder vote for the purpose of gaining more time to convince stockholders to approve a merger. Vice Chancellor Strine rejected the plaintiff's argument that the "primary purpose" of the special committee's action was to thwart the expression of the stockholders' will that should be subject to the *Blasius* "compelling justification" standard. Rather, the Vice Chancellor held that the actions of the Inter-Tel board should be examined under the *Unocal* standard.

In April 2007, Inter-Tel agreed to be acquired by its competitor Mitel Networks Corp. and private equity firm Francisco Partners for \$26.50 per share in cash. A special meeting of shareholders to vote on the proposed merger was scheduled for June 29, 2007. On June 13, 2007, a large institutional shareholder announced that it was seriously considering opposing the merger, and Institutional Shareholder Services ("ISS") (presently RiskMetrics Group, the largest proxy advisor in the United States) subsequently recommended that Inter-Tel stockholders vote against the transaction. Inter-Tel had not conducted an auction prior to signing the merger agreement, and ISS believed its adverse recommendation might help Inter-Tel extract a higher price. In addition, as an alternative to the Mitel merger, Inter-Tel's founder made a proposal to buy 60% of the company's shares at \$28 per share. However, on June 22, Mitel issued a press release stating that it would not increase its price, citing Inter-Tel's lower-than-expected quarterly earnings.

As the date for the special meeting approached, Inter-Tel's special committee came to understand that a majority of the shares would likely be voted against the merger. On the morning of June 29, the special committee decided to postpone the special meeting to allow stockholders more time to digest recent developments, including deterioration of the debt capital markets, Inter-Tel's lower-than-expected sales numbers, the announcement by Mitel that it would not raise its bid, and the filing of definitive proxy materials by the company's founder in connection with his recapitalization proposal. Inter-Tel's full board ratified the postponement, set the vote for July 23 and changed the record date for the special meeting to July 9, 2007. Thereafter, ISS changed its recommendation to favoring the merger, the founder withdrew his recapitalization proposal, and the stockholders approved the merger on the new special meeting date.

A shareholder sued to enjoin the merger, alleging that the special committee breached its fiduciary duty by, among other things, thwarting the will of Inter-Tel's stockholders by postponing the special meeting at the eleventh hour when it knew the proposed merger would be voted down. The plaintiff also complained that the change in the record date permitted hedge funds and arbitrageurs to acquire Inter-Tel stock they would vote in favor of the merger to gain a short-term profit.

In declining to enjoin the merger, Vice Chancellor Strine stated that, in situations where a vote "touch[es] on matters of corporate control," the appropriate standard of review is a "reasonableness standard consistent with the *Unocal* standard."n15 The Vice Chancellor noted that the "[t]he core of *Unocal's* utility" rests in the burden it imposes on directors: (1) to identify the proper corporate objectives served by their actions; and (2) to justify their actions as reasonable in relationship to such objectives.n16 Vice Chancellor Strine explained further that

directors are not supposed to be neutral with regard to matters the propose for stockholder action. As

a matter of fiduciary duty, directors should not be advising stockholders to vote for transactions ... unless the directors believe [they] are in the stockholders' best interests.n17

Vice Chancellor Strine concluded that the special committee's objective in rescheduling the special meeting--to improve the chances that stockholders would approve the proposed merger by a more fully informed vote--was proper and legitimate. The Vice Chancellor also found that a short delay in the special meeting was a reasonable action in relation to the special committee's objective and that by delaying the meeting, the special committee had not precluded the stockholders from voting or coerced them into voting in a particular way. Accordingly, the court held that the actions of Inter-Tel's special committee satisfied the reasonableness standard of *Unocal*.

The Vice Chancellor further found that, even if the *Blasius* standard applied, Inter-Tel's special committee had demonstrated a compelling justification for its actions. According to the Vice Chancellor, compelling circumstances exist where (1) directors believe that stockholders are about to reject a transaction that is in their best interests, (2) information useful to the stockholders' decision has not been publicly disclosed or adequately considered and (3) if the stockholders vote against the transaction, the buyer will walk and the opportunity will be irretrievably lost.n18

By contrast, in *Steel Partners II, L.P. v. Point Blank Solutions, Inc., C.A. No. 3695-CC*,n19 the Delaware Supreme Court applied the *Blasius* test to an attempt by Point Blank Solutions, Inc. to postpone its annual meeting of shareholders in order to pursue a possible sale. On April 8, 2008, Point Blank announced the postponement of its annual meeting, which was originally scheduled for April 22, 2008, until August 19, 2008, in order to allow the company additional time to pursue possible strategic alternatives. The company's most recent annual meeting had been held in 2005. After the company's April 8, 2008 announcement, shareholder Steel Partners II, L.P., which was seeking to elect a slate of directors in furtherance of a takeover attempt, brought suit pursuant to Section 211 of the DGCL to compel the company to hold an annual meeting. The company, after agreeing to hold its annual meeting not later than August 19, 2008, made a motion to postpone its annual meeting until November 19, 2008 in order to complete its exploration of strategic alternatives.

In support of its request for postponement, the company alleged that Steel Partners and the former CEO of Point Blank together controlled approximately 40 percent of the company's voting power. The company argued that because Steel Partners was a potential buyer of the company, the slate of directors that Steel Partners had nominated, if elected, would be conflicted and would seek to sell the company to Steel Partners at the lowest possible price. The company also alleged that the former CEO had a personal interest adverse to the company's public shareholders because he was litigating a claim to advancement fees against the company and a breach of contract claim filed by the company against him.

The court, citing *Blasius* and *Liquid Audio*, held that the company's allegations failed to provide a basis upon which the shareholder franchise could be "further impinged by any additional delay of the exercise of that fundamental right."n20 The court noted that, although it recognized that the influence that Steel Partners and the former CEO might have on the outcome of a shareholder vote, the company's proper recourse under the circumstances was to communicate its concerns directly to its stockholders. The court stated that it was "up to the stockholders to vote their prerogative" after evaluating all the information made available to them, and there was no good cause shown to further delay their ability to do so.n21

By contrast, the *Blasius* standard has been held to be applicable to a provision in a poison pill that prevents any directors, other than those who are in office at the time the pill was adopted or their designated successors, from redeeming the pill (a "dead hand" provision). In *Carmody v. Toll Brothers Inc.*,n22 the court held that the *Blasius* standard was applicable to such a provision, in that the shareholders had been disenfranchised because the provision deprived them of their ability to elect a board willing and able to accept a hostile bid.n23

In *Chesapeake Corp. v. Shore* n24 the Delaware Chancery Court struck down bylaw amendments adopted by the

directors of a target company in the face of a tender offer. The court found that the bylaw amendments--which included a requirement for a supermajority vote to amend the bylaws--were designed to make it harder for a bidder to change the target's bylaws so as to declassify the board and elect a new board that favored the bidder's offer. Vice Chancellor Strine found that, under *Unocal*, this was an unreasonable response to the bidder's offer. The Vice Chancellor thought the threat posed by the offer was modest, since it was an all-cash offer, and the target's poison pill gave directors time to explain to shareholders why they believed the offer was inadequate.ⁿ²⁵

The Vice Chancellor also held that the supermajority requirement added by the bylaw amendment had a preclusive effect, leaving the bidder with no realistic chance of winning a consent solicitation, since the target's directors owned about 24 percent of the company's stock and had determined to oppose the consent solicitation. After reviewing the evidence of proxy solicitors of both sides, the court concluded it was reasonable to expect that about 90 percent of the shares would vote in the consent solicitation, and that the bidder would need the affirmative vote of holders of over 88 percent of the shares voted to prevail.ⁿ²⁶ The Vice Chancellor also found that the bylaw amendment interfered with the shareholder franchise and therefore found it invalid under *Blasius* without a showing of compelling justification--which the court found to be lacking.ⁿ²⁷

It is likely that courts in other states, too, will give careful scrutiny to defensive actions that have the effect of disenfranchising shareholders. After Hilton Hotels Corporation launched a hostile tender offer for ITT Corporation, a federal district court, applying Nevada law, enjoined ITT from implementing without a shareholder vote a spinoff of most of ITT's assets into a company having a staggered board. ITT itself did not have a staggered board. The court noted that "interference with the shareholder franchise is especially serious [and] ... is not to be left to the board's business judgment, precisely because it undercuts a primary justification for allowing directors to rely on their business judgment in almost every other context."ⁿ²⁸

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Business & Corporate Law Corporations Shareholders

FOOTNOTES:

(n1)Footnote 1. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) .

(n2)Footnote 2. *Blasius*, 564 A.2d at 661-62 .

(n3)Footnote 3. *MM Companies Inc. v. Liquid Audio Inc.*, 813 A.2d 1118 (Del. 2003) .

(n4)Footnote 4. *Liquid Audio*, 813 A.2d at 1130 (citing *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992)) .

(n5)Footnote 5. *Liquid Audio*, 813 A.2d at 1131-32.

(n6)Footnote 6. *Liquid Audio*, 813 A.2d at 1130.

(n7)Footnote 7. *Kidsco, Inc. v. Dinsmore*, 674 A.2d 483, 485-89, 496 (Del. Ch. 1995) . See also *Golden Cycle, LLC v. Allan, C.A. 16301, 1998 Del. Ch. LEXIS 80, at *21-23 (Del. Ch. May 20, 1998)* , in which the court declined a bidder's request for an injunction against the fixing of a record date by the target company before a consent solicitation. The target on March 30 fixed the record date as March 30. The court noted that a record date was needed and that there was an insufficient basis from which to conclude that the date actually fixed would interfere with the bidder's consent solicitation in a material respect.

(n8)Footnote 8. *Aquila, Inc. v. Quanta Servs., Inc.*, 805 A.2d 184 (Del. Ch. 2002) .

(n9)Footnote 9. *Aquila*, 805 A.2d at 198-202 .

- (n10)Footnote 10. *Aquila*, 805 A.2d at 205 .
- (n11)Footnote 11. *Aquila*, 805 A.2d at 205-06 (quoting *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992)) .
- (n12)Footnote 12. *Aquila*, 805 A.2d at 205-06 ; see also *In re MONY Group S'holders Litig.*, 853 A.2d 661, 677 (Del. Ch. 2004) (holding that a board's action in setting a new record date for a merger vote did not fall within the category of actions to which the "compelling justification" standard applies under *Blasius* but, rather, was subject to the business judgment rule).
- (n13)Footnote 13. *Aquila*, 805 A.2d at 203 , 207-08.
- (n14)Footnote 14. 929 A.2d 786 (Del. Ch. 2007) .
- (n15)Footnote 15. 929 A.2d at 810 .
- (n16)Footnote 16. *Inter-Tel*, 929 A.2d at 807.
- (n17)Footnote 17. 929 A.2d at 809 .
- (n18)Footnote 18. 929 A.2d at 813 .
- (n19)Footnote 19. 2008 Del. Ch. LEXIS 107 (Del. Ch. Aug. 12, 2008) .
- (n20)Footnote 20. *Steel Partners*, 2008 Del. Ch. LEXIS 107, at *4 (citing *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) ; *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003)) .
- (n21)Footnote 21. 2008 Del. Ch. LEXIS 107, at *5 .
- (n22)Footnote 22. *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180 (Del. Ch. 1998) .
- (n23)Footnote 23. *Carmody*, 723 A.2d at 1193 .
- (n24)Footnote 24. *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) .
- (n25)Footnote 25. *Chesapeake*, 771 A.2d at 331-33 .
- (n26)Footnote 26. *Chesapeake*, 771 A.2d at 333-44 .
- (n27)Footnote 27. *Chesapeake*, 771 A.2d at 344-45 .
- (n28)Footnote 28. *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1351 (D. Nev. 1997) , *aff'd*, 116 F.3d 1485 (9th Cir. 1997) .



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Corporate Governance: Law and Practice

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.07

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§ 12.07 The Entire Fairness Test

[1] Introduction

Under Delaware case law, the most exacting standard for judicial review of a decision by directors is the "entire fairness" test, which requires the courts to determine whether the decision is entirely fair to the stockholders.

The entire fairness standard is applicable if a majority of the directors has an actual conflict of interest in approving a transaction, such as where directors stand on both sides of a transaction.ⁿ¹ The Delaware Court of Chancery held in *In re Tele-Communications, Inc. S'holders Litig. Cons. C.A. No. 16470*,ⁿ² that a conflict requiring the demonstration of entire fairness also exists where directors are significant non-majority shareholders of a corporation and have personal interests in a transaction between the corporation and a third party that significantly diverge from those of other equity holders.ⁿ³ In the TCI case, which arose out of TCI's merger with AT&T Corp. in 1999, TCI had two classes of stock, Class A and Class B. The two classes had identical economic rights, but Class A had one vote per share, whereas Class B had ten. John Malone, TCI's controlling stockholder, insisted from the outset of merger discussions with AT&T that, in order to obtain his consent to the transaction, the Class B shares must receive a 10 percent premium (valued at \$240 million) relative to the Class A shares. The TCI directors held significantly more Class B shares than Class A shares, while the public shareholders held predominantly Class A shares. Moreover, Class B was almost entirely comprised of members of the board: 84 percent of the outstanding Class B shares were held by five directors, which constituted a majority of the board. Thus, any premium exclusively granted to the Class B shares would primarily benefit these directors rather than the public shareholders. The court observed that based on the AT&T common stock price on the date immediately before the date on which the board approved the merger, these five directors would have received an additional \$220 million premium at the expense of the Class A shareholders. Because such a significant benefit accrued primarily to directors controlling such a large vote of the corporation, at the expense of another class of shareholders to whom these directors owed a fiduciary duty, the court concluded that the entire fairness standard should apply.ⁿ⁴

The entire fairness test is also applicable to a going private transaction that is a corporate transaction such as a merger--rather than a tender offer⁵- and that involves a controlling shareholder.⁶ In analyzing a transaction under the entire fairness standard, Delaware courts look at both the procedural fairness ("fair dealing") and the substantive or price fairness ("fair price").⁷

Even if the entire fairness test is applicable, it is not necessary to show that the price paid was the highest price the bidder could have afforded to pay. As the Delaware Supreme Court said in *Cinerama*, "a finding of perfection is not a *sine qua non* in an entire fairness analysis."⁸

In *In re Pure Resources, Inc. S'holders Litig.*,⁹ Vice Chancellor Strine identified two strands of authority in the relevant Delaware case law.¹⁰ In one strand, which applies to situations where controlling shareholders negotiate a merger agreement with the target board to buy out the minority, the cases emphasize the protection of minority shareholders against unfairness caused by the "inherent coercion" that exists in such transactions.¹¹ In the other strand, which deals with cases where a controlling shareholder seeks to acquire the minority's shares through a tender offer followed by a short-form merger, Delaware case precedent "facilitates the free flow of capital between willing buyers and willing sellers of shares, so long as the consent of the sellers is not procured by inadequate or misleading information or by wrongful compulsion."¹²

[2] Negotiated Mergers

A going private transaction involving a controlling shareholder that is structured as a negotiated merger--or that otherwise requires the target's board of directors to take action to facilitate the transaction--must satisfy the test of entire fairness, rather than the normal business judgment rule.¹³ Moreover, the entire fairness form of review governs negotiated going private transactions involving a controlling shareholder even if the target board was comprised of a majority of independent directors, a special committee of the target's independent directors was empowered to negotiate and veto the merger, and the merger was subject to approval of a majority of the disinterested target shareholders.¹⁴

Nevertheless, although normally the controlling shareholder has the burden of showing that the transaction meets the entire fairness standard, if the transaction is negotiated and approved by a special committee of independent directors that has the freedom to negotiate at arm's length, the burden of persuasion on the issue of entire fairness shifts from the controlling shareholder and the target board as proponents of the transaction in question to shareholder-plaintiffs challenging it, unless the functioning of the special committee in negotiating and approving the transaction is flawed in some way.¹⁵ Similarly, the burden of proof on the issue of entire fairness may be shifted to the plaintiff if the merger is conditioned on the approval of a majority of the publicly held shares, provided there is adequate disclosure to the public shareholders.¹⁶

In a management buyout ("MBO"), the transaction should not be subject to a test of entire fairness unless the buying group dominates the target company's board. However, special committees are often used in MBO transactions as a way of addressing the conflicts of interests these transactions present.

[3] Going Private Tender Offers

In going-private transactions involving tender offers, the controlling shareholder typically promises to buy as many shares as the minority will sell, but conditions the offer on enough minority shares being tendered for it to obtain 90 percent of the target's shares, so that the controlling shareholder can then consummate a short-form merger under the Delaware short-form merger statute,¹⁷ at either the same or a different price. The Delaware courts have held that the entire fairness test does not apply to going private transactions structured as tender offers by controlling shareholders.

In *Solomon v. Pathe Communications Corp.*,¹⁸ the Delaware Supreme Court held that, unlike in negotiated merger

transactions, a controlling shareholder making a non-coercive tender offer to acquire shares directly from the minority holders does not have a duty to offer a "fair" price in the proposed tender offer.ⁿ¹⁹ In *In re Siliconix S'holders Litig.*,ⁿ²⁰ the Delaware Chancery Court explained the difference in the way courts treat going-private transactions structured as tender offers followed by short-form mergers, as opposed to going-private transactions structured as long-form mergers:

The difference in judicial approach can be traced to two simple concepts. The first is that accepting or rejecting a tender is a decision to be made by the individual shareholder, and at least as to the tender itself, he will, if he rejects the tender, still own the stock of the target company following the tender. The second concept is that the acquired company in the merger context enters into a merger agreement, but the target company in the tender context does not confront a comparable corporate decision because the actual target of a tender is not the corporation (or its directors), but, instead, is its shareholders.ⁿ²¹

However, for the business judgment rule standard of review to apply to a going-private tender offer, two conditions must be satisfied. First, the tender offer must be voluntary and non-coercive, in contrast to "inherently coercive" cash-out mergers. Second, there must be no materially false or misleading disclosures made to shareholders in connection with the offer.ⁿ²²

Unlike the "inherent coercion" that *Lynch* held to exist where a controlling shareholder seeks to acquire the minority's stake in a negotiated merger, "in the tender offer context addressed by *Solomon* and its progeny, coercion is defined in the more traditional sense as a wrongful threat that has the effect of forcing stockholders to tender at the wrong price to avoid an even worse fate later on," a type of coercion ... [called] "structural coercion."ⁿ²³ In *Pure Resources*, the Delaware Chancery Court held that there is no actionable structural coercion if the controlling shareholder:

- makes the tender offer subject to a non-waivable majority of the minority tender condition;
- promises to effect a short-form merger at the same price if it obtains 90 percent or more of the shares; and
- makes no retributive threats (e.g., to cut the dividend or to delist the stock if the tender offer is not successful).ⁿ²⁴

With regard to the adequate disclosure condition, Vice Chancellor Strine explained in *Pure Resources* that "[t]he informational and timing advantages possessed by controlling stockholders require some countervailing protection if the minority is to truly be afforded the opportunity to make an informed, voluntary tender decision."ⁿ²⁵ To that end, the *Pure Resources* court held that a controlling shareholder making a tender offer for the minority's shares has a duty under Delaware law to make disclosure in the tender offer of "all material facts pertinent to the decisions that they [the minority shareholders] are being asked to make."ⁿ²⁶ This duty may go beyond the specific line items of the applicable SEC form.

Further, Vice Chancellor Strine stated that, to compensate for its informational and timing advantages, the controlling shareholder "owes a duty to permit the independent directors on the target board both free reign and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment."ⁿ²⁷

Finally, the court held that for their part, the independent directors of the target have a duty to undertake these tasks in good faith and diligently, and to pursue the best interests of the minority.ⁿ²⁸ However, there is no duty on the part of the board to give the special committee the power to block the tender offer, through use of a poison pill or otherwise, nor any duty on the part of the independent directors to seek such blocking power.ⁿ²⁹

[4] Short-Form Mergers

The Delaware Chancery Court has held that the entire fairness test does not apply to short-form mergers under Section 253 of the Delaware General Corporation Law.ⁿ³⁰ Vice Chancellor Lamb stated in *In re Unocal Exploration Corp. S'holders Litig.*ⁿ³¹ that, when a controlling shareholder consummates a statutory short-form merger that is not preceded by any prior transaction subject to entire fairness review, in the absence of "fraud, gross overreaching, or other such wrongful conduct" or inadequate disclosure, the only remedy of an unhappy minority shareholder is appraisal.ⁿ³² The court reasoned that a rule imposing an equitable requirement of fair process on statutory short-form mergers would be inconsistent with the statute's authorization of a simplified procedure for such mergers.ⁿ³³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Shareholders Actions Against Corporations Business & Corporate Law Corporations Shareholders Appraisal & Dissent Rights

FOOTNOTES:

(n1)Footnote 1. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) .

(n2)Footnote 2. 2005 Del. Ch. LEXIS 206 (Del. Ch. Dec. 21, 2005) .

(n3)Footnote 3. 2005 Del. Ch. LEXIS 206, at *26 .

(n4)Footnote 4. 2005 Del. Ch. LEXIS 206, at *25-30 .

(n5)Footnote 5. A going private tender offer that is coercive--in the sense that it involves a "wrongful threat that has the effect of forcing stockholders to tender at the wrong price to avoid an even worse fate later on"--may also be subject to the entire fairness standard of review. See *In re Pure Resources S'holders Litig.*, 808 A.2d 421, 438 (Del. Ch. 2002) .

(n6)Footnote 6. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) . See also *In re Siliconix Inc. S'holders Litig.*, Cons. C.A. 18700, 2001 Del Ch. LEXIS 83 (Del. Ch. June 19, 2001) , where the Delaware Court of Chancery rejected the argument that the Delaware Supreme Court's decision in *McMullin v. Beran*, 765 A.2d 910 (2000) , required application of the entire fairness standard to going private transactions involving a tender offer by a controlling shareholder for the stock held by the minority shareholders, to be followed by a short-form merger. As Vice Chancellor Noble pointed out, in *McMullin*, the Supreme Court was careful to note that the duties involved in that case were statutory duties under the Delaware merger statute and "attendant" fiduciary duties. Because the Supreme Court in *McMullin* emphasized that fiduciary duties are "context specific," the Vice Chancellor declined to read into the *McMullin* holding a new approach to assessing the conduct of directors of a tender target. *Siliconix*, 2001 Del. Ch. LEXIS 83, at *7-9 .

(n7)Footnote 7. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1985) ; *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1115 (Del. 1994) .

(n8)Footnote 8. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1179 (Del. 1995) .

(n9)Footnote 9. *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002) .

(n10)Footnote 10. *Pure Resources*, 808 A.2d at 435 .

(n11)Footnote 11. *Pure Resources*, 808 A.2d at 435 . See also *Emerald Partners v. Berlin*, 787 A.2d 85, 95 (Del. 2001) ("the category of transactions that require judicial review pursuant to the entire fairness standard *ab initio* do so

because, by definition, the inherently interested nature of those transactions are inextricably intertwined with issues of loyalty"). This strand is discussed in 12.07[2] below.

(n12)Footnote 12. *Pure Resources*, 808 A.2d at 435 . This strand is discussed in 12.07[3] below.

(n13)Footnote 13. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) . See also *Emerald Partners v. Berlin*, 787 A.2d 85, 94 (Del. 2001) (reiterating that entire fairness applies where controlling shareholder stands on both sides of challenged transaction).

(n14)Footnote 14. *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1117 (Del. 1994) . In contrast, in a negotiated going private transaction involving a significant, but non-controlling, shareholder, who may sit on the board or have the right to appoint one or more directors to the board, a properly constituted and functioning committee of disinterested directors can ensure that the deferential "business judgment" standard of review will apply. See, e.g., *Kohls v. Duthie*, 765 A.2d 1274, 1285 (Del. Ch. 2000) (management buyout led by CEO who owned 35 percent of corporation's stock). In an article discussing the standards of judicial review in Delaware, former Delaware Chancellor William Allen and Vice Chancellors Leo Strine and Jack Jacobs suggested that the business judgment rule should apply to "self-interested mergers that are approved by either an effective independent committee or by a majority of the minority shareholder vote." William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 *Bus. Law* 1287, at 1317 (2001).

(n15)Footnote 15. *Pure Resources*, 808 A.2d at 436 (citing *Lynch*, 638 A.2d at 1117 ("An approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.")). See also *Levco Alternative Fund Ltd. v. Reader's Digest Ass'n*, 803 A.2d 428 (Del. 2002) (citing *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999)) . Note also that, while the entire fairness standard remains applicable to the actions of the controlling shareholder in a negotiated going private transaction, the use of a properly functioning special committee of disinterested, independent and informed directors will result in the application of the business judgment rule to the decisions of the directors sitting on the special committee. See, e.g., *In re Western Nat'l Corp. S'holders Litig.*, C.A. 15927, 2000 Del. Ch. LEXIS 82 (Del. Ch. May 22, 2000) .

(n16)Footnote 16. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985) . However, the Delaware Supreme Court has held in a case involving the merger of a public company with an 80-percent majority shareholder into a third company (unaffiliated with the majority shareholder) that the board of the target has "an affirmative duty to protect [the] minority shareholders' interests" and to assist the minority shareholders by ascertaining the target's value as a going concern so that the shareholders may make an informed decision as to whether to pursue appraisal rights. *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) . At the very least, this holding implies that, even where a controlling shareholder seeks to rely on a "majority of the minority" condition to shift the burden of proof, it should institute a special committee process in order for the target's board to meet its duty to advise the public shareholders how to vote on the merger. In *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005) , Vice Chancellor Strine reasoned that a going private transaction negotiated with and approved by an independent committee, and subject to approval of a majority of the publicly held shares, should not be subject to entire fairness review.

(n17)Footnote 17. Del. Gen. Corp. L. § 253.

(n18)Footnote 18. 672 A.2d 35 (Del. 1996) .

(n19)Footnote 19. *Solomon*, 672 A.2d at 39-40 . See also *Pfeffer v. Redstone*, C.A. No. 115, 2009 Del. LEXIS 37, at *11-12 (Del. Jan. 23, 2009) ("Delaware law does not impose a duty of entire fairness on controlling stockholders making a non-coercive tender or exchange offer to acquire shares directly from the minority holders") (quoting *Aquila*, 805 A.2d at 190); *Pure Resources*, 808 A.2d 421 ; *Siliconix*, 2001 Del. Ch. LEXIS 83, at *22 ("as a general principle, our law holds that a controlling shareholder extending an offer for minority-held shares in the controlled corporation is

under no obligation, absent evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way, to offer any particular price for the minority-held stock") (quoting *In re Ocean Drilling & Exploration Co. S'holders Litig.*, C.A. 11898, 1991 Del. Ch. LEXIS 82, *9-10, Chandler, V.C., mem. op. at 6-7 (Apr. 30, 1991)); *Joseph v. Shell Oil Co.*, 482 A.2d 335, 341 (Del. Ch. 1984) .

(n20)Footnote 20. *In re Siliconix Inc. S'holders Litig.*, C.A. 18700, 2001 Del. Ch. LEXIS 83 (Del. Ch. June 19, 2001) .

(n21)Footnote 21. *Siliconix*, 2001 Del. Ch. LEXIS 83, at *26 .

(n22)Footnote 22. *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421, 438 (Del. Ch. 2002) (citing *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 39 (Del. 1996)) .

(n23)Footnote 23. *Pure Resources*, 808 A.2d at 438.

(n24)Footnote 24. *Pure Resources*, 808 A.2d at 436, 451-52. See also *In re Aquila, Inc. S'holders Litig.*, 805 A.2d 184, 188, 190 (Del. Ch. 2002) (holding that a tender offer was not coercive and "clearly a voluntary one" because the terms of the offer included a majority of the minority condition and a commitment to effect a short-form merger on the same terms if the offer was successful). See also *In re Next Level Communications, Inc. S'holders Litig.*, 834 A.2d 828 (Del. Ch. 2003) (applying the framework applied in *Pure*, the court refused to enjoin an offer by a 74 percent holder that it found to be both structurally non-coercive and fully and fairly disclosed).

(n25)Footnote 25. *Pure Resources*, 808 A.2d at 438.

(n26)Footnote 26. *Pure Resources*, 808 A.2d at 447. In *Pure Resources*, the court enjoined a going private tender offer in part because of nondisclosure of the valuation analyses of the financial adviser to the special committee and inadequate disclosure of the parent company's reasons for undertaking the transaction and of the proceedings of the special committee (which had sought a broader grant of authority but had been rebuffed). Similarly, in *In re Emerging Communications S'holder Litig.*, C.A. No. 16415, 2004 Del. Ch. LEXIS 70, at *111-*15 (Del. Ch. May 3, 2004) , the Delaware Court of Chancery applied the entire fairness standard to a negotiated two-step going private transaction where the controlling shareholder omitted to disclose material information in the tender offer documents and the proxy statement. Moreover, the court held that this material omission "[was] sufficient, in and of itself, to undermine the informed character of the Special Committee approval that is a predicate to shifting the burden of proof in an entire fairness case." *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *114 . Nor was the burden shifted by the condition that a majority of the minority shareholders tender into the offer, because conditioning a tender offer that is part of a going private transaction does not have the same burden-shifting effect as conditioning a merger on approval by holders of a majority of the publicly held shares. *Id.* The court explained that "no Delaware case has held that burden-shifting can be accomplished by a tender of shares rather than by an actual vote. Nor should a tender be treated as the equivalent of an informed vote Stockholders have materially different interests at stake when tendering as opposed to voting their shares." *Id.* at *114-15.

(n27)Footnote 27. *Pure Resources*, 808 A.2d. 421, 445 at n.47. (stating that the foregoing "is not to slight the controlling stockholder's fiduciary duty of fair disclosure and its duty to avoid misleading the independent directors and the minority"). However, the court also stated that there is no duty on the part of the controlling shareholder to permit the target board to block the tender offer through the use of a poison pill. 808 A.2d 445, 446 .

(n28)Footnote 28. *Pure Resources*, 808 A.2d. at 445 . Cf. *In re Siliconix Inc. S'holders Litig.*, CA 18700, 2001 Del. Ch. LEXIS 83 (June 19, 2001) , where the court declined to extend the *McMullin* doctrine to tender offers or to impose on the board of the target a duty to take an affirmative position on a proposed tender offer by a controlling shareholder. However, in *Pure Resources*, Vice Chancellor Strine, seemingly alluding to the then-recently enacted Sarbanes-Oxley Act of 2002 and the then-recently proposed SRO governance rules, also noted that "whether a majority stockholder can compose a subsidiary board entirely of persons beholden to itself and use this fact as the reason for

depriving the minority of a board recommendation is a question about which I need not speculate, and which recent corporate governance developments suggest will not likely need to be answered definitively." *Pure Resources*, 808 A.2d. at 445 n.48 .

(n29)Footnote 29. *Pure Resources*, 808 A.2d. at 446 . For a post-*Pure Resources* decision permitting a going-private tender offer to go forward because it was structurally non-coercive and entailed sufficient disclosure, see *Next Level Communications v. Motorola*, 834 A.2d 828 (Del. Ch. 2003) . In that case, the court found there was adequate disclosure of the large stockholder's projections for the target and, by the target in its Schedule 14D-9, of the target's more bullish projections. The court also found that the offer was not made coercive by the disclosure of the facts that the target company needed additional funding and had been threatened with de-listing from Nasdaq.

(n30)Footnote 30. *In re Unocal Exploration Corp. S'holders Litig.*, 793 A.2d 329 (Del. Ch. 2000) , *aff'd sub nom.*, *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001) . Under Del. Gen. Corp. L. § 253, a corporation can merge with its 90-percent owned subsidiary without any action of the subsidiary's board.

(n31)Footnote 31. 793 A.2d 329 (Del. Ch. 2000) , *aff'd sub nom.*, *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001) .

(n32)Footnote 32. *Unocal Exploration*, 793 A.2d at 338 .

(n33)Footnote 33. *Unocal Exploration*, 793 A.2d at 338 n.26 .



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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.08

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§ 12.08 Shareholder Ratification

In *Smith v. Van Gorkom*, the Delaware Supreme Court described it as the "settled rule" that "where a majority of fully informed shareholders ratify action of even interested directors, an attack on the ratified transaction normally must fail."ⁿ¹ However, in 2009, the Delaware Supreme Court held in *Gantler v. Stephens* ⁿ² that shareholder ratification is inapplicable to any situation in which the shareholder vote is required by law.

The *Gantler* case arose out of a sale process for First Niles Financial, Inc., a small, Nasdaq-listed bank holding company. Although the company received three bids, no sale resulted: the board declined to pursue one bid that expressly stated the bidder's intention not to retain the First Niles board; another bid was withdrawn after First Niles failed to provide requested due diligence materials; and a third bid, a proposed stock merger, was rejected by the board without discussion or deliberation. Instead, the board pursued a "privatization" transaction in which shares of holders of 300 or fewer shares were reclassified into a preferred stock with no voting rights other than upon a sale of the company, and the company's shares were de-listed from Nasdaq. The reclassification was approved by holders of a majority of First Niles's outstanding shares. Plaintiff shareholders alleged that the defendant directors and officers breached their fiduciary duties by rejecting the stock merger proposal and abandoning the sale process, by disseminating a false and misleading proxy statement, and by effecting the reclassification.

The Delaware Chancery Court dismissed the complaint.ⁿ³ The court held that *Unocal* did not apply to the board's decision not to sell the company because the board itself initiated the sale process and there was no hostile takeover attempt or any threatening action to indicate that the board's actions were "defensive" in nature. The court applied the business judgment rule and held that, where a board decides not to pursue a merger, the board must (1) reach its decision "in good faith pursuit of legitimate corporate interests" and (2) it must do so "advisedly."ⁿ⁴ On the first question, the court found that there was no evidence that the directors acted for the primary purpose of entrenching themselves in office. On the second question, the court held that the extensive discussions that the board had with its

financial adviser concerning the offers and the involvement of specially retained outside counsel made the plaintiffs' allegations insufficient to infer that the board did not act with due care. The Chancery Court also agreed with the defendants that because First Niles shareholders ratified the reclassification, the board's decision to effect the reclassification was protected by the business judgment rule under *Smith v. Van Gorkom*.ⁿ⁵ On appeal, the Delaware Supreme Court, sitting *en banc*, reversed.

The Delaware Supreme Court agreed with the Chancery Court's view that the board's decisions to reject the merger proposal and abandon the sale process were not subject to enhanced scrutiny under Unocal because the actions of the board could not properly be called "defensive."ⁿ⁶ However, the court found that the board was not eligible for the protection of the business judgment rule at this stage because the plaintiffs had adequately alleged conflicting interests. While acknowledging that the prospect of directors losing their jobs was in itself insufficient to support an allegation of disloyalty, the court noted that the proxy statement for the reclassification conceded that First Niles' directors and officers had a conflict because each could structure the reclassification "in such a way that benefits his or her interests differently from the interests of unaffiliated shareholders."ⁿ⁷ In addition, the complaint alleged that one director was president of a company that provided heating and air conditioning services to the bank, and that another director was a principal in a law firm that represented First Niles and the bank. Lastly, allegations of the President, Chairman and CEO's "unexplained" failure to respond to a bidder's due diligence request and to inform the board of the due diligence problem, together with the bidder's stated intention to terminate the incumbent board, were sufficient for the Court to infer that the CEO had acted disloyally.ⁿ⁸

In considering the claims against the defendants who were officers of First Niles, the Delaware Supreme Court explicitly held that the fiduciary duties of officers are the same as those of directors--a rule a number of Delaware cases had assumed, but one not previously expressly embraced by the Delaware Supreme Court--and that the plaintiffs had adequately pled that First Niles officers breached their duties by "sabotaging" the due diligence process.ⁿ⁹ The court noted an important difference between the consequences of an officer's and a director's fiduciary breach: unlike directors, officers cannot be exculpated for breaches of the duty of care under DGCL § 102(b)(7).ⁿ¹⁰

The Delaware Supreme Court next held that the Chancery Court erred by dismissing the plaintiffs' disclosure claims, holding that complaint sufficiently alleged that the disclosure in the proxy statement stating that the board rejected the merger proposal only after "careful deliberations" was materially misleading because it failed also to disclose the circumstances under which one of the bidders withdrew, the insufficient deliberations by the board, and the directors' personal financial motivations in effecting the reclassification.ⁿ¹¹

Finally, the Delaware Supreme Court rejected the shareholder ratification defense accepted by the Chancery Court. The court could have done so on the limited basis that the proxy disclosure was defective, making informed ratification impossible. Instead, the court stated that the scope and effect of the common law doctrine of shareholder ratification were "unclear," and that, to "restore coherence and clarity to this area," the shareholder ratification doctrine "must be limited to its so-called 'classic' form; that is, to situations where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective."ⁿ¹² The court went further, narrowing the scope of the doctrine by holding that "the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve," and that, with one exception (ratification of an action the directors lacked authority to make), shareholder ratification does not extinguish a challenge to director action, but rather subjects the challenged action to business judgment review.ⁿ¹³ The Delaware Supreme Court overruled *Smith v. Van Gorkom* to the extent it holds otherwise.ⁿ¹⁴

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate LawCorporationsShareholders

FOOTNOTES:

(n1)Footnote 1. 488 A.2d 858 (Del. 1985) (quoting *Gerlach v. Gillam*, 139 A.2d 591, 593 (Del. Ch. 1958) .

(n2)Footnote 2. *Gantler v. Stephens*, C.A. No. 132, 2009 Del. LEXIS 33 (Del. Jan. 27, 2009) .

(n3)Footnote 3. *VCP*, 2008 Del. Ch. LEXIS 20 (Del. Ch. Feb. 14, 2008) .

(n4)Footnote 4. *Gantler*, 2008 Del. Ch. LEXIS 20, at *35-36 (citing *TW Services, Inc. v. SWT Acquisition Corp.*, Cons. C.A. Nos. 10427, 10298, 1989 Del. Ch. LEXIS 19, at *36-38 (Del. Ch. Mar. 2, 1989)).

(n5)Footnote 5. 2008 Del. Ch. LEXIS 20, at *57-68, *84 .

(n6)Footnote 6. *Gantler*, 2009 Del. LEXIS 33, at *19-21 .

(n7)Footnote 7. 2008 Del. Ch. LEXIS 20, at *26 .

(n8)Footnote 8. 2008 Del. Ch. LEXIS 20, at *27-28 .

(n9)Footnote 9. 2009 Del. LEXIS 33, at *30-32 .

(n10)Footnote 10. 2009 Del. Ch. LEXIS 33, at *31 & n.37.

(n11)Footnote 11. Del. Ch. LEXIS 33, at *33-40.

(n12)Footnote 12. 2009 Del. LEXIS 33, at *44 .

(n13)Footnote 13. Del. Ch. LEXIS 33, at *44.

(n14)Footnote 14. Del. Ch. LEXIS 33, at *45 & n.54.



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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.09

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§ 12.09 Responding to a Third-Party Takeover Proposal

[1] Introduction

As the foregoing review indicates, there is a wide array of standards that can be applied to reviewing the decisions of the directors of a target company in response to a takeover proposal. From a counseling point of view, however, much of the case law boils down to elaborations of the two fundamental duties applicable to corporate directors: the duty of loyalty and the duty of care. In deciding upon an appropriate response to a takeover proposal, directors should act with the best interests of the corporation and its shareholders in mind, and should act carefully and in an informed manner.

There is no cookbook recipe for what is needed to discharge these basic duties in all cases. Directors' responses must be tailored to the facts and circumstances of the particular takeover proposal. Nevertheless, some approaches are generally applicable to show that the directors of a target have acted carefully and loyally. These include:

- adequate notice and the absence of unnecessary rush;
- proper documentation;
- adequate information;
- appropriate reliance on experts; and
- minimization of conflicts of interest.

[2] Adequate Notice and the Absence of Unnecessary Rush

If practicable, directors should be informed of the nature of the proposed transaction before the meeting at which they have to consider it. The absence of such advance notice proved to be a devastating factor against the defendants in *Smith v. Van Gorkom*,ⁿ¹ a case in which the Delaware Supreme Court found that target company directors were grossly negligent in approving a proposed merger.

Courts recognize that some decisions--especially those made during a hostile tender offer--may have to be made expeditiously. As the Delaware Chancery Court has noted, "[t]he time constraints and rush of events which occur when a company is 'in play' dictate a quick response by the board of a target company."ⁿ² If, however, there is no business reason for haste, the record should show the absence of precipitate action.

After *Van Gorkom*, it has become more common for boards of directors considering a response to a takeover proposal--whether an unsolicited tender offer or a negotiated merger--to have more than one meeting before deciding on a course of action. The board may have at least one information meeting, to understand and discuss fully the proposal, the discussions with the bidder and the alternatives and a second meeting to decide finally, and take formal action on, whether to accept or reject the acquisition proposal.

[3] Proper Documentation

In *Van Gorkom*, neither the chief executive nor any other director of the target company had read the merger agreement before it was signed. This fact clearly troubled the court. More recent cases not involving mergers have underscored the importance of careful review by directors of important draft agreements.ⁿ³

If at all possible, directors should be sent drafts of the major documents in advance of the meeting at which they are asked to take action with respect to a takeover or other acquisition proposal--for example, in the case of an unsolicited takeover offer, the bid and information about the bidder; in a negotiated merger, the merger agreement. It may be helpful also to send a summary of the main documents. Often it is desirable for the target company's management or the target's advisers (the investment bankers and the lawyers) to take time at the meeting to summarize the key terms of the documents not previously reviewed by the board, including the differences from previous drafts sent to the board.

[4] Adequate Information

The target company's board should consider the "material facts that are reasonably available."ⁿ⁴ The information furnished to the directors will depend very much on the nature of the proposed transaction and the circumstances of the target company. Here are some of the elements that may be appropriate to serve as a basis for informed decision-making:ⁿ⁵

- *The transaction or proposal.* What is the offer or proposed transaction that the board is being asked to accept or reject? What are its economic terms? What are the principal conditions to the purchaser's obligations? If the transaction is subject to financing, what is the bidder's ability to obtain financing? What is the risk of non-completion--for example, for failure to satisfy the conditions in the proposal, or because of antitrust or other regulatory problems? It is also helpful for the directors to be informed of the background of the transaction--for example, who approached whom, and the course of negotiations between the parties.
- *Current information about the target company and its prospects.* If the directors have not been recently informed by management of the state of the company's business and prospects, and how the company is doing relative to its forecast, it is generally appropriate to bring the directors up to date on these matters before the directors decide whether or not to accept an acquisition proposal.
- *The fairness of the offer.* In reviewing the adequacy and fairness of the offer, it is helpful for the

board to review the historical trading prices for the company's shares. In addition, with the assistance of experts (such as investment bankers), a board might compare (a) the proposed price as a multiple of various measures (such as the target's historical or projected earnings, book value, cash flow, etc.) to (b) the corresponding multiples represented by (i) the prices of the publicly traded shares of comparable companies and (ii) prices that other acquirors have paid in comparable transactions. Another method that allows the board to assess the adequacy of the proposed price is a discounted cash flow analysis, which gives some indication (beyond the current price of the publicly traded shares) of the company's value as a stand-alone enterprise (based on various assumptions).ⁿ⁶

If the proposed transaction is a stock-for-stock merger, it is typical for the target's directors to be given information as to the bidder's business and prospects (since the transaction will involve an investment decision to replace an investment in the target company with an investment in the bidder's stock). Information could also include information as to the implied exchange ratio based on historical trading prices for both companies' stock; the pro forma effect of the transaction on book value and earnings per share; and a comparison of the percentage of stock of the combined entity to be owned by shareholders of the target company with the percentage that the target company will contribute to the combined enterprise's sales, earnings and book value.

It is relevant to analyze the shareholder profile of the combined company. Will there be one or more controlling shareholders? If so (unless the target company had a controlling shareholder before the transaction), the directors of the target company (if it is a Delaware company) may be obliged to seek the best price reasonably available. In addition, it is often helpful in a stock-for-stock merger to provide information as to how the merger achieves strategic objectives for the target company.

- *Impact on constituencies.* How will the bid affect non-shareholder constituencies of the target company--for example, employees, customers, suppliers, and the communities in which the company does business?ⁿ⁷
- *Timing.* Is now the right time for the target company to engage in a sale or a merger? Is it likely that the target company's shareholders would do better if the sale happened in the future?
- *Alternatives.* What are the alternatives to the proposed transaction? Continuing the company as a stand-alone company without major change; a restructuring or recapitalization of the target company? A transaction with another bidder? What alternative transactions has management or its representatives explored?

[5] Appropriate Reliance on Experts

Under Delaware General Corporation Law Section 141(e), and comparable provisions of other state corporation statutes, a director is protected if the director relies in good faith in the performance of his duties on information presented to the company by a person as to matters the director reasonably believes are within the person's professional or expert competence, if the person has been selected with reasonable care by or on behalf of the company.

An investment banker's opinion is not legally required. That is particularly true if there is no conflict of interest, of the sort that exists in a management leveraged buyout. Nevertheless, investment bankers can help to analyze a proposed transaction, and to assist the target's directors in evaluating the fairness of the proposed transaction (including by examining the likelihood that the company can create comparable or greater shareholder value without doing the transaction). Legal advice is also important concerning the directors' fiduciary duties in responding to an acquisition proposal, the nature of the antitrust or other regulatory issues presented by the proposal, the details of the transaction agreement, and the relevant tax considerations.

[6] Minimization of Conflicts of Interest

If directors have an interest on the other side of a proposed corporate transaction, they should disclose that interest to the other directors. If the other directors approve the transaction after such disclosure, that tends to demonstrate the fairness of the transaction.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Shareholders Appraisal & Dissent Rights Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares Business & Corporate Law Corporations Shareholders Transfers of Shares

FOOTNOTES:

(n1)Footnote 1. *Smith v. Van Gorkom*, 488 A.2d 858 at 874 (Del. 1985) . See also *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 614 (Del. Ch.) , *aff'd per curiam*, 316 A.2d 619 (Del. 1974) (preliminary injunction issued against a major asset sale because, among other things, management failed to give directors notice of the subject matter of the meeting at which the sale was considered).

(n2)Footnote 2. *Moran v. Household Int'l Inc.*, 490 A.2d 1059, 1075 (Del. Ch. 1985) , *aff'd*, 500 A.2d 1346 (Del. 1985) .

(n3)Footnote 3. See, e.g., *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) .

(n4)Footnote 4. *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) .

(n5)Footnote 5. For a non-exclusive list by the Delaware Supreme Court of factors a target's board may wish to consider before authorizing a defensive action to resist a takeover bid, see *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989) .

(n6)Footnote 6. The Delaware Supreme Court referred to discounted cash flow analysis as well as the relevant informational components in *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1995) and in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-13 (Del. 1993) .

(n7)Footnote 7. In *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989) , the Delaware Supreme Court stated that, in investigating whether there was a threat to corporate policy and effectiveness under *Unocal*, the board's analysis could include the impact of a transaction on non-shareholder constituencies (provided that there is some reasonable relationship to general shareholder interests).



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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

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§ 12.10 Responding to a "Going Private" Offer from a Controlling Shareholder

[1] Introduction

In a going private transaction, a large shareholder of a publicly held company proposes to take the company private by buying out the public's stockholdings. Transactions involving financial sponsors joining with management to acquire a target company are also commonly referred to as "going private" transactions--although, as discussed further below, these transactions (sometimes referred to as "management buyouts" or "MBOs") raise somewhat different issues from those arising in the classic case of an acquisition by a controlling shareholder.

Here are some of the special issues and problems that make a going private transaction different from an acquisition by an unaffiliated buyer:

- *The buyer has conflicting interests.* The large shareholder typically is represented on the board of the company (and, in the case of an MBO, some of the managers participating in the transaction are often also board members). The directors appointed by the large shareholder--and the large shareholder itself, if it is a controlling shareholder--have fiduciary obligations to the public shareholders of the company. At the same time, the buyer's financial interest is to pay as little as possible to buy out the public shareholders.
- *A higher legal standard may apply.* If the large shareholder is a controlling shareholder, the transaction may be subject to a higher legal standard under applicable state corporation law. For example, in Delaware, a going private transaction structured as a long-form merger (that is, as a transaction that must be approved by the board of directors of the target) must satisfy a test of "entire fairness," rather than the normal business judgment rule test.¹

- *The potential for litigation is greater.* Because of the conflicting interests of the buyer and the public shareholders, and the different legal test, going private transactions tend to produce litigation.
- *A special committee of outside directors should review the proposal.* To address the conflicts noted above, and to make the transaction as arm's length as possible, the company's board of directors typically appoints a special committee of outside directors to review the acquisition proposal, negotiate with the buyer and make recommendations to the full board. The special committee appoints its own financial and legal advisers, at the company's expense.
- *Enhanced disclosure requirements apply.* Going private transactions that buy out the minority's stockholdings for cash are subject to enhanced disclosure requirements under the federal securities laws.ⁿ²

Because of these special issues and problems, the directors--in particular, the disinterested directors--of the target company that receives a going private proposal need to proceed even more carefully than the directors of a target company that receives a third party acquisition proposal.

[2] The Controlling Shareholder and the Special Committee

Going private transactions are not all the same. Before starting to work on a going private transaction, those advising the board should look closely at the facts relating to each of the key players in the cast.

Start with the large shareholder. Is it a single entity, or a group of entities (such as a major shareholder and members of management) working together to take the company private? Alternatively, if the transaction is an MBO, what is the relationship between the managers and the private equity sponsor? What information has been provided to the private equity sponsor, and by whom? What agreements have been reached between the managers and the sponsor? What percentage of the company's stock is owned by the large shareholder(s) or management? Does the large shareholder already have majority control? If not, is its ownership high enough so that the public could not--without the large shareholder's approval--sell control and get a control premium? In the case of the MBO, does the private equity sponsor (or any of its affiliates) own any shares of the target company's stock? Does the buyer have sufficient shares, and are the remaining shares sufficiently widely held, such that the buyer would have a reasonable prospect of obtaining 90% of the outstanding shares in a tender offer? If the large shareholder is not yet a majority stockholder, is it subject to any standstill agreement limiting its ability to increase its holdings?ⁿ³ Does the target company have a poison pill that would restrict the ability of the large shareholder to buy additional shares of the target?

What are the buyer's objectives and business purpose in the proposed transaction? Why does it want to buy out the public at this precise moment? Are there market inefficiencies--for example, the company's public float is so small that analysts and institutional investors do not follow the company, or the company is in a sector that is out of favor--that result in the public market's not appropriately reflecting the company's value? Are these short-term factors--a hiccup or two that make now an opportunistic time to buy out the public on the cheap--or a reflection of long-term trends?ⁿ⁴ Is the large shareholder a potential seller, or only a buyer? In case of MBO, are managers free--and willing--to work with other private equity sponsors? If private equity sponsors are involved, do they have any existing portfolio companies that make them particularly logical buyers because of their industry knowledge or ability to achieve synergies? What is the appropriate process for the target company to evaluate the proposed transaction--a pre-signing market check in the form of a broad public auction or private contacts with a limited number of likely buyers, or an exclusive negotiation with the buyer followed by a post-signing market check?

Next look closely at the special committee. Are the members truly independent, or do they have some financial interest in the large shareholder or in the large shareholder's paying as little as possible for the public interest in the company?

Consulting or other financial arrangements with the controlling shareholders--including service on the boards of other companies controlled by the controlling shareholder, and even the expectation of continued service on the board of the privatized target--may be held to vitiate independence.ⁿ⁵ Apart from economic interests, do committee members have other ties with the large shareholder that might call into question the independence and disinterestedness of the members of the committee?ⁿ⁶ A special committee member's stockholdings in the company are not disqualifying, and in fact serve to align the member's interests with those of public shareholders.ⁿ⁷ Is there more than one member of the special committee? Courts may give particularly careful scrutiny to a case in which there is only one member of the committee.ⁿ⁸

A special committee should select its own financial and legal advisers--not blindly choose ones suggested by the large shareholder.ⁿ⁹ Who are the special committee's advisers, and how have they been chosen? Do the committee's advisers do any work for the large shareholder, or have any other relationships that bring into question their independence from it?

[3] The Work of the Special Committee and Its Legal Advisers

At the outset, the special committee and its legal advisers will want to be comfortable that the special committee's charter--that is, its authorization in resolutions adopted by the full Board--is sufficiently broad.

For example, is the special committee authorized only to approve or disapprove the large shareholder's initial proposal, or is it also authorized to negotiate with the large shareholder? The record is better if the special committee is authorized to negotiate. Under Delaware case law,ⁿ¹⁰ a long-form merger with a controlling shareholder must be shown to be entirely fair to the public shareholders, but the burden shifts to the plaintiff to show that the transaction was not entirely fair if the transaction is negotiated by a special committee of independent directors that has the freedom to negotiate at arm's length, and that in fact does so.ⁿ¹¹ To shift the burden, "the committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arms-length.'" ⁿ¹²

Is the special committee also authorized to explore alternatives? Is that realistic, given the large shareholder's stockholdings? Is the large shareholder a potential seller, or only a buyer? Often, the large shareholder will make clear in its initial proposal that it has no interest in selling its position. If so, and if the large shareholder has a controlling position, then the task of the special committee, under the Delaware case law, becomes, not to obtain a full control premium for the public shareholders, but to get the best price available from the large shareholder for a non-controlling block of stock.ⁿ¹³

The resolutions setting up the special committee should also make clear that the committee is authorized to hire its own advisers at the company's expense. Often, the resolutions will spell out the compensation to be paid to the chairman and members of the special committee,ⁿ¹⁴ and will make clear that committee members are to be indemnified by the company to the fullest extent permitted by applicable law. Appendix 16-A to this chapter contains model resolutions to establish a special committee to consider a going private proposal.

To establish that the special committee has done its work carefully, so as to shift the burden of proof to the plaintiff, it is important to make a record of the meetings of the committee, including telephonic meetings, with appropriate minutes reflecting the members' knowledge of the company's business and their careful consideration of the issues.ⁿ¹⁵

[4] The Financial Adviser's Work

[a] Selecting The Financial Adviser

As noted earlier, the special committee typically will engage a financial advisor, usually an investment bank, to help it

evaluate the large shareholder's proposal. The financial advisor's tasks would include understanding the value of the target, assisting the special committee in its negotiations with the large shareholder and, if requested, furnishing an opinion as to the fairness of the proposal from a financial point of view.

In selecting its financial adviser, the special committee should inquire into whether a potential adviser has done business for or is otherwise beholden to the large shareholder. If the financial adviser is part of a multi-function financial services organization, the special committee should consider ties and business relationships of affiliates of the financial adviser (for example, banking relations, underwritings, or other advisory relationships).¹⁶ Note that the adviser's recent material business relationships both with the company and with the large shareholder must be disclosed to the company's shareholders.¹⁷

[b] Terms of the Financial Advisor's Engagement

The terms of the financial advisor's engagement will be set out in a formal engagement letter. Each investment bank has its own form of engagement letter.

How is the financial adviser to be compensated? If the transaction were an acquisition of the company by an unaffiliated third party, you would expect to see the target company's investment banker receive most of its fee only on closing of the transaction. In a going private transaction, it might be argued that such a fee structure would tend to give the special committee's financial adviser an economic incentive to issue a favorable opinion as to the fairness of the transaction so as to make it more likely that the transaction will close (and that the advisor would receive a transaction fee).¹⁸

For this reason, it is not uncommon in a going private transaction to see most or all the financial adviser's fee (apart from an initial portion intended to compensate the adviser for the cost of the time needed to become familiar with the company's business) become payable when the financial adviser, at the special committee's request, is prepared to deliver its opinion (favorable or unfavorable) about the proposed transaction with the large shareholder. In addition, any portion of the fee payable upon closing is often due even if the transaction proceeds without the approval of the special committee.

Other aspects of the financial adviser's engagement letter also tend to look different from an engagement letter in a third party acquisition. The letter should make clear that the special committee is engaging the financial adviser and will be requesting the adviser's opinion, but that the company will be paying the adviser's fee and indemnifying it against third party claims. The letter typically will contemplate that the adviser's fairness opinion will be addressed to the special committee--but may also state that all the directors (including the conflicted directors) may rely on it.

[c] The Fairness Opinion

The financial adviser's opinion typically will be as to fairness from a financial point of view of the consideration to be received by the public shareholders.¹⁹ Each investment bank will use its own form of opinion. Depending on the facts, the financial adviser's opinion might include, in addition to the usual assumptions (such as: the projections from management have been reasonably prepared on bases reflecting management's best current estimates; the representations are true and correct; the covenants will be performed and the conditions satisfied):

- the financial adviser's understanding, based on the large shareholder's statements, that the large shareholder has no interest in any transaction that would result in the sale of its shareholdings in the company;
- the fact that the financial adviser was not requested or authorized to solicit, and did not solicit, proposals from third parties relating to the acquisition of the company; and

- the fact that the financial adviser had been informed by the large shareholder that it had no intention to pursue a sale of the company after consummating the transaction.

The special committee's financial adviser, before rendering its opinion, should undertake an appropriate "due diligence" review of the company and its prospects and review valuations of comparable public companies and comparable transactions.

[d] Board Books and Disclosure Issues

The special committee will wish to have the benefit of "board books" containing summaries of the financial adviser's analyses. The financial adviser will need to be cautious in preparing even preliminary "board books," since they may need to be filed with the SEC. Under the federal going private rule, Exchange Act Rule 13e-3, an issuer or affiliate engaging in a "Rule 13e-3 transaction" (for example, a tender offer or merger solicitation as a result of which the company's shares will no longer be listed on an exchange or quoted on NASDAQ) must file a Schedule 13E-3 statement with the SEC. The statement must specify whether the company or its affiliate has received any "report, opinion (other than an opinion of counsel) or appraisal from an outside party which is materially related to the Rule 13e-3 transaction."²⁰ The statement must also contain a summary of the report, opinion or appraisal (including the findings and the bases for and methods of arriving at the conclusions contained therein), and a copy of the report, opinion or appraisal must be filed as an exhibit to the Schedule 13E-3.²¹

What about drafts of the adviser's analyses? The company and the special committee may well take the position that a draft is not a "report or opinion" and that only the final board book--the one considered by the special committee and the board in approving the going private transaction--is covered by the rule. But the SEC staff, in its comments on the Schedule 13E-3, is likely to request all drafts of the analyses that were furnished to the special committee or the board, and may request inclusion in the text of the merger proxy statement or the tender offer of a description of any material differences between earlier drafts and the final board book.

What if the financial adviser for the special committee prepares a talking paper that is used solely in bargaining with the other side, in an effort to encourage the large shareholder to increase its bid? The special committee's counsel may take the position that talking points for bargaining are not a "report, opinion ...or appraisal" that is materially related to the transaction, but the SEC staff tends to read the disclosure requirement broadly.²²

Apart from disclosure requirements under federal securities laws, state law may impose a separate disclosure obligation, which may require detailed disclosure of the investment banker's financial analysis, even if such disclosure is not required by the line items of the relevant SEC forms. In *In re Pure Resources, Inc. S'holders Litig.*, Delaware Vice Chancellor Strine noted a historical ambivalence in Delaware law with respect to disclosure of the financial analysis of investment bankers.²³ The Vice Chancellor then stated that in his view, "this ambivalence [should] be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely."²⁴

Vice Chancellor Strine reasoned that although the law should not encourage unnecessary prolixity, that concern does not apply to investment bankers' analyses, "which usually address the most important issue to stockholders--the sufficiency of the consideration being offered to them for their shares in a merger or a tender offer."²⁵ Moreover, in Vice Chancellor's view, "the disclosure of the banker's 'fairness opinion' alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability."²⁶ He concluded that "[t]he real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result."²⁷ Subsequent cases have emphasized that *Pure Resources* "establishes that stockholders of Delaware corporations 'are entitled to a fair summary of the substantive work performed by investment bankers.'"²⁸

Must the financial projections underlying the financial adviser's fairness opinion be disclosed? Several Delaware cases decided in 2007 and 2008 suggest that the answer depends on whether the projections are "material"--which requires a facts-and-circumstances analysis.

In *Netsmart Technologies, Inc. Shareholders Litig.*,ⁿ²⁹ the Delaware Chancery Court held that a merger proxy statement was materially incomplete because it failed to disclose the projections used by the target's financial adviser to perform the discounted cash flow valuation supporting its fairness opinion. Although Netsmart's proxy statement contained two sets of management projections, neither was identical to the final projections used by the financial adviser in preparing its fairness opinion. In particular, the projections used by the financial adviser included projections for 2010 and 2011, while the disclosed projections ended at 2009.

The *Netsmart* defendants argued that the undisclosed projections were not material because, among other things, they were not provided to any of the bidders, and the omitted 2010 and 2011 estimates were too distant--and therefore too speculative--to require disclosure. The court disagreed, pointing out that the fact that the 2010 and 2011 projections were not provided to bidders did not undercut the materiality of those forecasts to Netsmart's stockholders. Unlike the bidders, the Netsmart stockholders had been presented with the fairness opinion and were being asked to make an important voting decision to which the company's prospects were directly relevant. Moreover, although the proxy statement clearly stated that the discounted cash flow analysis performed by the financial adviser covered the period from January 1, 2007 to December 31, 2011 and that approximately 82 percent to 86 percent of the present value of Netsmart's enterprise value was attributable to the terminal value calculated from the 2011 projected EBITDA, nowhere in the proxy was there any financial information covering that "critical, terminal year (or the prior year for that matter)."n30

According to the court, when a financial adviser's endorsement of the fairness of a proposed transaction is touted to stockholders, the valuation methods used by the financial adviser to arrive at its fairness opinion as well as the "key inputs and range of ultimate values generated by those analyses must also be fairly disclosed."n31 Providing only a portion of that information is insufficient to fulfill the duty of providing a "'fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of the ... board as to how to vote ... rely.'"n32

In contrast, in *In re CheckFree Corp. S'holders Litig.*,ⁿ³³ the Delaware Chancery Court declined to enjoin a stockholder vote on a merger where the target's proxy statement failed to disclose management's financial projections used by the target's financial adviser in analyzing the fairness of the merger price. In *CheckFree*, the court found that the proxy statement detailed the various sources upon which the financial adviser relied, explained some of the assumptions and calculations on which management's estimates were based and described management's estimates of the target company's earnings and EBITDA for the current year and two subsequent years. In addition, the proxy statement explained that, in conveying its estimates to the financial adviser, management had discussed with the bankers the particular risks it foresaw that might undercut those estimates. Accordingly, the court concluded that the proxy statement contained an "adequate and fair summary" of the work performed by the financial adviser and noted that the plaintiffs had to explain "why receiving information in addition to the basic financial data already disclosed [would] significantly alter the total mix of information available."n34

Moreover, the court concluded that this analysis was not altered by *Netsmart*. In *Netsmart*, the proxy statement "affirmatively disclosed an early version of some of management's projections."n35 Because management must give materially complete information "[o]nce a board broaches a topic in its disclosures," the *Netsmart* court held that additional disclosure was required.n36 In contrast, CheckFree's proxy statement never purported to disclose management's projections.

Similarly, in *Globis Partners, L.P. v. Plumtree Software, Inc.*,ⁿ³⁷ the Delaware Chancery Court dismissed the plaintiff's

claim that Plumtree's merger proxy statement was false and misleading because, among other things, it failed to provide projections of the target's future performance and product pipeline. The court explained that the omitted information was not material merely because it might be helpful and that disclosure that does not include all financial information necessary to make an independent determination of fair value is not per se misleading or materially incomplete. The fact that the target's financial advisers may have considered certain non-disclosed information does not change this analysis. The court concluded that, given the extensive disclosure of the key terms, purposes and anticipated effects of the proposed merger, none of the omitted information could have been viewed by a reasonable stockholder as significantly altering the total mix of available information.ⁿ³⁸

The court further noted that unreliable projections may in fact be misleading. In explaining why the financial adviser determined that a discounted cash flow analysis would be inappropriate for its valuation, Plumtree stated that its intermediate and long-term visibility was very limited. The court pointed out that the plaintiff did not allege that Plumtree in fact had reliable projections or any other facts that reasonably would have called into question the veracity of that disclosure.ⁿ³⁹

The Delaware Chancery Court recently expanded on the *CheckFree* and *Globis Partners* line of cases in *Simonetti Rollover IRA v. Margolis*.ⁿ⁴⁰ In this case, a shareholder of The TriZetto Group, Inc. sought a preliminary injunction to prevent a proposed merger between TriZetto and Apax Partners, L.P. The plaintiff alleged, among other things, that TriZetto's merger proxy statement failed to disclose that the financial projections used by the target's investment banker in preparing its fairness opinion were the most conservative of three sets of projections prepared by TriZetto's management.

The court noted that a proxy statement should give the shareholders the "best estimate" of the company's future cash flows as of the time the board approved the transaction.ⁿ⁴¹ In this connection, Delaware law "places a premium on management's predictions of future performance."ⁿ⁴² The court found that the record indicated that the projections used by the investment banker reflected management's best estimates at the time. Therefore, the court concluded that, although including the more optimistic projections in the proxy statement and then explaining why they were not relied upon may have been somewhat helpful to shareholders, such additional disclosures would not have materially altered the total mix of information provided.ⁿ⁴³

Target companies should keep in mind that, even if a particular presentation or other analysis is not required to be filed with the SEC, it will almost certainly have to be provided to plaintiff's counsel if there is litigation challenging the transaction. Both the special committee and the financial adviser (and their respective counsel) should take care to make sure that these documents do not have inconsistencies that cannot be explained.

[5] Going Private Transactions Involving Financial Sponsors

Although MBOs are not generally subject to a test of entire fairness, they do involve a higher litigation risk--and greater disclosure obligations--than other acquisition transactions because of the target company management's conflict of interests. As a result, the special committee structure used for going private transactions involving controlling shareholders is frequently used in MBOs as well. MBO transactions involving financial sponsors also raise the following particular issues:

- *Group status.* Management members joining to pursue an MBO--with or without a financial sponsor--may inadvertently form a group having separate legal status under state anti-takeover laws (*e.g.*, Section 203 of the Delaware corporation statute), poison pills and change of control provisions in the target company's debt documents, employment agreements, benefit plans, joint venture and other agreements. Formation of a group can also trigger disclosure obligations under Section 13(d) of the Exchange Act.--It may be possible to deal with this issue by expressly providing, in any arrangements among a buying group, that all agreements or understandings among the parties are subject to special

committee approval, although particular care needs to be taken here given the potentially dire consequences--particularly under a poison pill and state anti-takeover laws--of the premature formation of a group.

- *Process.* Private equity sponsors generally have a strong preference to negotiate an MBO through an exclusive, non-public process, rather than a pre-signing auction process, whether public or private. As discussed further below, whether to go along with this approach will be one of the earliest--and potentially among the most important--decisions that the special committee will have to make in responding to a going-private proposal.

- *Role of management.* The special committee will often want to ensure that the target company's management does not reach agreement with any particular financial sponsor as to the terms of management's post-transaction employment and equity participation arrangements, in order to ensure that other financial sponsors can compete on an equal footing. Particularly if there is no pre-signing market check, these restrictions should survive the signing in order to maximize the ability of competing sponsors to make bids between signing and closing.

- *Financing.* MBOs typically require debt financing, and the extent to which obtaining financing is a condition to the buyers' obligation to close is often a topic of intense negotiation. Prior to the credit crisis that began in the summer of 2007, the trend that developed in large going private transactions involving financial sponsors was not to condition the transaction on obtaining financing, but instead to have a reverse termination fee payable by the buyers if financing cannot be obtained--thereby limiting the buyers' potential exposure for failing to close.⁴⁴ Whether or not a transaction is subject to a financing condition, the special committee and its advisers will want to review carefully the buying group's financing commitments to ensure that they are not substantially more conditional than the merger agreement itself.

[6] Structuring The Transaction

Structuring a going private transaction raises a number of basic issues. These include:

- Should the transaction be structured as one-step merger or a two-step transaction with a tender offer followed by a merger?
- Should the transaction be conditioned on the support of a majority-of-the-minority?
- What if no agreement can be reached between the special committee and the controlling shareholder?
- How will the transaction be financed?
- The need for expanded SEC disclosure.
- The increased likelihood of shareholder litigation.
- The need to be especially mindful of the process.

[a] One-Step vs. Two-Step

Should the transaction take the form of a one-step merger, or be effected pursuant to a merger agreement that

contemplates a tender offer as its first step? The company's shareholders will usually get their money sooner in a tender offer than in a merger, because there is no need for prior SEC review before launching a tender offer, as there is before a merger proxy statement can be mailed. Moreover, if enough stock is tendered in the tender offer, the merger typically could be effected on a short-form basis, with the approval of controlling shareholder's directors only, and without the need for a meeting of the company's shareholders or the solicitation of proxies.

From the point of view of the buyer, there are other reasons to prefer a first-step tender offer. The company's shareholders will not have any appraisal rights with respect to shares that they tender (although they would have appraisal rights with respect to the second-step cash-out merger). Moreover, as noted above, while under the Delaware case law a controlling shareholder must offer a fair price in a merger,ⁿ⁴⁵ a controlling shareholder does not, subject to the principles discussed above, have a fiduciary duty to offer a fair price in a non-coercive tender offer, since that is viewed as a transaction with shareholders rather than with the corporation, and the transaction is not subject to the test of "entire fairness." In a tender offer, the controlling shareholder does, however, have a duty under the Delaware case law to disclose all material information.

Despite these considerations, many negotiated transactions are structured as one-step mergers rather than as tender offers followed by a back-end merger. Assuming that the large shareholder owns a majority of the target company, there is no chance of a topping bid and hence, from the large shareholder's perspective, little benefit to the shortened time period in which the first-step tender offer can be closed. It is also usually substantially easier to finance a one-step transaction, as it facilitates the granting of security interests at closing and avoids margin loan concerns.ⁿ⁴⁶

[b] Majority-of-the-Minority Condition

Should the merger be conditioned on approval by holders of a majority of the company's publicly held shares (or if there is a first-step tender offer, should it be conditioned on tender of a majority of the publicly held shares)?

As discussed above, under the Delaware case law, if there is adequate disclosure to the public shareholders, conditioning a merger on approval by a majority of the publicly held shares will shift to the plaintiff the burden of showing that the transaction is not entirely fair. In a tender offer context, making the tender offer subject to a non-waivable majority-of-the-minority tender condition will help the controlling shareholder show that the offer is non-coercive and, therefore, is not subject to the entire fairness test, although in either case care must be taken to be sure that the publicly held shares are defined so as to exclude holders who have an economic interest (other than as target shareholders) in effecting the transaction (for example, directors or officers of the controlling shareholder, or target employees with severance agreements).ⁿ⁴⁷

On the other hand, particularly if the public float is small, conditioning the deal on approval by a majority of the public float may invite gamesmanship by hedge funds and other arbitrageurs. Moreover, if the transaction is a merger rather than a tender offer, the controlling shareholder may see little incremental benefit from such a minimum condition because, if the special committee is appropriately constituted and does its job correctly, that in itself should shift to the plaintiff the burden of showing that there was something not entirely fair about the transaction.ⁿ⁴⁸

[c] Failure to Reach an Agreement

One of the primary functions of the special committee is to negotiate with the buyer. Typically, the process will commence with an offer by the large shareholder made in writing to the target company's board, or by a request by the large shareholder that the board form a special committee for the purpose of receiving and evaluating an offer to be made formally once the special committee is established.

Once the board or the special committee receives a going-private proposal, an early decision will be whether to make the offer public--assuming that the large shareholder has not itself already made a public announcement. In some cases,

either the large shareholder or the special committee will publicly announce the proposal and the fact that the special committee has been formed, for various reasons, including to avoid the possibility of leaks or selective disclosure. In addition, special committees often find that the reaction of the target company's stockholders and the analyst community can be useful data points in negotiating with the large shareholder.ⁿ⁴⁹

Recently, however, it has become increasingly common, particularly in transactions involving private equity sponsors, for the parties to keep the negotiations confidential until the terms of the transaction have been agreed upon and a merger agreement signed. The Delaware Supreme Court has made clear that there is "no single blueprint" for seeking the best value in a change of control.ⁿ⁵⁰ An auction is one way; signing up with one bidder and having a post-signing canvassing of the market is another. Whatever method is used, however, it must be "designed to determine the existence and viability of possible alternatives."ⁿ⁵¹ The courts have blessed a variety of approaches.ⁿ⁵²

If the special committee determines not to pursue a pre-signing market check, it should be prepared to explain its reasoning, including as to potential risks to the business from following a different process, its views as to the quality of the proposal on the table, and its efforts and ability to inform itself about alternatives. A recent trend has been for financial sponsors to negotiate going private deals on a confidential, exclusive basis, but subject them to a "go shop" provision that allows the target company, for a limited period post-signing, actively to solicit competing bids.ⁿ⁵³ Often, the break-up fee payable by the target company if it terminates the merger agreement to accept a topping bid is lower if the topping bid is made by a party that emerges during the "go shop" period.ⁿ⁵⁴

In terms of the negotiations themselves, the buyer's initial proposal will in most cases not represent its best price. Rather, the buyer will often start with a reasonable offer (typically at a substantial premium over the pre-announcement market price) and negotiate upwards. Such a negotiation may help to demonstrate that the special committee has effectively represented the interests of the public shareholders, and that therefore the burden in shareholder litigation challenging the transaction should be on the plaintiff to show that the transaction is not entirely fair.ⁿ⁵⁵

What if the buyer is not willing to increase its bid price to a level the special committee is willing to recommend? In this case, the buyer will typically have the option of taking its offer directly to the target company's shareholders, by a tender offer, without having a merger agreement that must be approved by the target's directors--although in some cases the buyer may be constrained from proceeding with a tender offer by the terms of a standstill agreement or by the existence of a poison pill rights plan preventing bidders from acquiring more than a specified threshold amount of the target's stock.ⁿ⁵⁶ Financial sponsors may also be limited by their agreements with investors in their funds, which often preclude the funds from participating in hostile bids. Even where such constraints do not exist, taking the offer directly to the target company's shareholders can be an uphill slog, as the special committee will control the target company's response to the tender offer and can be expected not only to recommend that the shareholders reject it but also put forth their analysis as to why the price being offered is inadequate. If, however, a controlling shareholder is heavy-handed about threatening the special committee that it will proceed with a tender offer at a lower price unless the special committee recommends the controlling shareholder's proposed merger, that kind of hardball tactic may result in the controlling shareholder's having the burden of proving the entire fairness of the transaction notwithstanding special committee approval.ⁿ⁵⁷

If the controlling shareholder does decide to go directly to the public by means of a tender offer--either because the controlling shareholder has been unable to reach agreement with the special committee or because there was no special committee process--it will often include a majority of the minority condition, in an attempt to get the benefit under Delaware law of having the tender offer not be subject to the entire fairness standard of review. The controlling shareholder might also condition the tender offer on obtaining sufficient shares that it can effect a short-form merger, thus avoiding the entire fairness test altogether.

Absent a standstill agreement or a poison pill rights plan preventing the large shareholder from proceeding with a tender offer, usually the only leverage available to the special committee to deter the controlling shareholder from going

directly to shareholders without special committee approval is the special committee's power to bestow or withhold its blessing of the transaction--or, in the words of the Delaware Chancery Court, "the power to say no."⁵⁸

If the special committee approves a transaction with the controlling shareholder after careful consideration, that will make the transaction harder for plaintiffs to attack in the courts. Conversely, if the controlling shareholder goes ahead with a tender offer at a price the special committee was unable to recommend, the shareholders will need to be informed of the special committee's position, and that position will make it harder for the controlling shareholder to obtain tenders from holders of a majority of the shares held by the public (if the tender offer is subject to a majority of the minority condition) or sufficient shares to effect a short-form merger. Moreover, if the controlling shareholder fails to obtain enough tenders for a short-form merger, the absence of the special committee's approval will also make it much more difficult for the controlling shareholder to demonstrate the fairness of the transaction in an ultimate cash-out merger.

[7] Financing the Deal

How is the transaction (and any related required debt refinancing) to be financed? If the real credit is not an equity infusion from the large shareholder, but the credit of the company itself, and if the transaction will leave the company highly leveraged or arguably with impaired capital or without the ability to pay its debts as they become due, it may be necessary to analyze whether the transaction could be viewed as an improper dividend to the company's shareholders under state dividend statutes--which typically would involve personal liability of directors to the company's creditors⁵⁹--or a fraudulent conveyance.

[8] Disclosure Issues

There is nothing private about going private; it is a transaction that happens in a goldfish bowl. Schedule 13E-3 and Regulation M-A, which contain the SEC's disclosure requirements for a going private transaction, call for much more disclosure than would be required for a tender offer or merger with an unaffiliated third party.

For example, in a going private transaction, disclosure must be made as to:

- all expenses incurred in connection with the transaction;
- the purpose of the transaction;
- what alternatives were considered and why they were rejected;
- the reasons for the structure of the transaction;
- why the transaction is being undertaken at this time;
- why the company or affiliate believes the transaction is fair;
- firm offers made by any third party for the company during the past 18 months;
- whether the transaction is structured so that approval of at least a majority of the public shares is required;
- any reports, opinions or appraisals relating to the consideration to be received or the fairness of that consideration (similar information is called for in third party merger proxy statements); and
- extensive financial information (including two years of audited financial statements and the most

recent quarterly interim financial statements of the company, and the pro forma effect of the transaction on the company).

Moreover, going private disclosure documents often attract SEC scrutiny. While all merger proxy statements are subject to review and comment by the SEC staff, the odds of being reviewed are higher, and the extent of the review greater, in a going private transaction than in an ordinary takeover.

As noted above, because of the target company management's conflict of interests, MBOs also involve greater disclosure obligations under state corporate law than other acquisition transactions. For example, in *In re Netsmart Technologies, Inc. S'holders Litig.*,ⁿ⁶⁰ *In re Topps Co. S'holders Litig.*,ⁿ⁶¹ and *In re Lear Corp. S'holder Litig.*,ⁿ⁶² the Delaware Chancery Court declined to enjoin the transactions on the basis of *Revlon* claims, but it did require corrective disclosure about the sale processes and management conflicts.

[9] Going Private Litigation

In light of the conflicting interests between the controlling shareholder and the public stockholders, it is not surprising that shareholder litigation is common in going private transactions. Shareholders may allege that the controlling shareholder has breached a fiduciary duty (if the transaction is a long-form merger)ⁿ⁶³ or has made inadequate disclosure.ⁿ⁶⁴ In the case of a merger, shareholders may also seek an appraisal of their shares.ⁿ⁶⁵ In *Gilliland v. Motorola*, the Delaware Chancery Court noted the general principle that, in a short-form merger, the "majority stockholder ... must disclose all information materially related to the decision whether to accept the consideration offered or seek appraisal."ⁿ⁶⁶ The Court stressed that "the fiduciary duty of disclosure requires that a notice of short-form merger either be accompanied by detailed disclosures or disclose summary financial information and adequately advise stockholders where and how to obtain more detailed information."ⁿ⁶⁷

Claims of breach of fiduciary duty are often made soon after a going private proposal is announced--even before the special committee has had a chance to retain advisers and decide whether to recommend the buyer's proposal.ⁿ⁶⁸ Plaintiff's counsel often will not seek expedited discovery or a preliminary injunction against the transaction while the special committee and the buyer are negotiating. If and when the buyer and the special committee agree on the terms of the transaction, the buyer may simultaneously enter into a memorandum of understanding with plaintiff's lawyers for the settlement of the shareholder litigation, subject to certain conditions, including confirmatory discovery as to the fairness of the transaction.ⁿ⁶⁹

[10] Minding the Process

To complete a going private transaction successfully requires continuous sensitivity to the conflicts inherent in the transaction. The better the process, the less likely a court will be to set aside the conclusions of the special committee and the company's full board as to the fairness of the transaction. Aspects of good process include:

- an independent and hard-working special committee, with a sufficiently broad authorization;
- knowledgeable and diligent legal and financial advisers to the special committee;
- at least if the transaction is a merger rather than a tender offer, a price that is demonstrably fair;
- if the transaction is a tender offer, a non-waivable majority-of-the-minority tender condition and a promise to effect a short-form merger at the same price if 90 percent or more of the shares are tendered;
- arm's length negotiations not involving retributive threats;

- a detailed and accurate record;ⁿ⁷⁰ and
- careful preparation of the disclosure documents.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Shareholders Meetings & Voting Voting Shares Mergers & Acquisitions Law

FOOTNOTES:

(n1)Footnote 1. *See* § 12.07[2] above.

(n2)Footnote 2. *See, e.g.*, 17 CFR §§ 229, 1013, 1014, 240.13e-3, 13e-4(e)(2).

(n3)Footnote 3. There are decisions involving going private transactions in which courts have found, on the facts and circumstances, that a large shareholder with less than 50 percent was a controlling person, owing a duty of fairness to the public shareholders. *See, e.g., Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1112 (Del. 1994) (43.3 percent shareholder designated five of 11 directors, opposed alternative transactions, and had a veto on alternative transactions because of a supermajority voting requirement in the company's charter); *In re Cysive, Inc.*, 836 A.2d 531 (Del. Ch. 2003) (Vice Chancellor Strine held that 40 percent ownership by CEO and CFO and family members should be deemed to be a controlling block so as to make the entire fairness test applicable; the analysis must take into account "whether the stockholder, as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation"); *Mendel v. Carroll*, 651 A.2d 297, 304 (Del. Ch. 1994) (family group that at all relevant times owned between 48 percent and 52 percent of a company's stock had the effective power to control the outcome of any stockholder election). On the other hand, in *In re Western Nat'l Corp. S'holders Litig.*, C.A. 15927, 2000 Del. Ch. LEXIS 82, at *26 (Del. Ch. May 22, 2000), the Chancery Court held that the ordinary business judgment rule, not the entire fairness standard, applied to a transaction with a 46 percent shareholder who was not represented on the target company's board of directors.

(n4)Footnote 4. In *In re Emerging Communications S'holder Litig.*, C.A. 16415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004), the Delaware Chancery Court held that the fact that a going private transaction was "timed in a manner that is financially disadvantageous to the [public] stockholders and that enable[d] the majority stockholder to gain correspondingly" was evidence of the absence of fair dealing that supported an award of damages against the controlling shareholder for breach of fiduciary duty.

(n5)Footnote 5. *CompuCom*, 2005 Del. Ch. LEXIS 145, at *28.

(n6)Footnote 6. *See, e.g., In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (denying a motion to dismiss derivative action based on the recommendation of a special litigation committee because of question as to non-economic ties between members of the committee and defendants in the derivative action).

(n7)Footnote 7. *Cf. In re Tele-Comms., Inc. S'holders Litig.*, (Del. Ch. Dec. 21, 2005) (questioning suitability of a member of a special committee that represented the interests of holders of one class of stock, where that member primarily held another class of stock receiving a premium to the class whose holders were represented by the special committee).

(n8)Footnote 8. *See, e.g., Gesoff v. IIC Industries Inc.*, 902 A.2d 1130 (Del. Ch. 2006); *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. 12489, 1996 Del. Ch. LEXIS 38 (Del. Ch. Mar. 29, 1996). In *In re Loral Space and Communications Inc.*, C.A. Nos. 2808-VCS, 3022-VCS, 2008 BL 222903, 2008 Del. Ch. LEXIS 136 (Del. Ch. Sept. 19, 2008), the Delaware Court of Chancery held that Loral's \$300 million securities purchase agreement with its largest shareholder, MHR Fund Management LLC, failed the entire fairness test because, among other things, the composition of the special committee was flawed. The special committee was composed of only two members, one of which had a

close relationship with MHR's principal who also served as Loral's chairman of the board. Moreover, neither committee member had any experience in the satellite industry. As a result, the special committee "immediately allowed itself to go down the most dangerous path for anyone dealing with a controlling shareholder--that of believing that its only option was to deal with the controller." *Loral Space, 2008 Del. Ch. LEXIS 136, at *29*. In particular, the special committee failed to conduct a market check or to contact other potential financing sources, one of which apparently had offered the same \$300 million investment on better economic terms. The court also found that Loral chose not to search for a buyer for the whole company because the company was controlled by MHR and its special committee and advisers were "passive." *Id. at *99*.

(n9)Footnote 9. *See, e.g., Kahn v. Tremont Corp., 694 A.2d 422, 426 (Del. 1997)* (in concluding that the defendants should still bear the burden of proof despite the use of a special committee, the court noted that the committee member with the closest ties to the controlling shareholder chose the advisers, and the company's general counsel, who was also general counsel for the affiliated company, suggested the committee's law firm); *In re Tele-Comms., Inc. S'holders Litig., (Del. Ch. Dec. 21, 2005)* (use of company's existing legal and financial advisers "raises questions regarding the quality and independence of the counsel and advice received"); *In re LNR Property Corp. S'holders Litig., 896 A.2d 169 (Del. Ch. 2005)* (special committee had its own counsel but used company's financial adviser); *Gesoff v. IIC Industries Inc., 902 A.2d 1130, 1138 (Del. Ch. 2006)* (committee had "no real authority" to choose its own lawyer or financial adviser); *Kahn v. Dairy Mart Convenience Stores, Inc., CA 12489, 1996 Del. Ch. LEXIS 38 (Del. Ch. Mar. 29, 1996)* (not helpful that the committee's investment banker was recommended by the controlling stockholder's counsel).

(n10)Footnote 10. As discussed in 12.07[2] above.

(n11)Footnote 11. *See, e.g., Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1117 (Del. 1994)*; *see also Emerald Partners v. Berlin, 726 A.2d 1215, 1223-24 (Del. 1999)*.

(n12)Footnote 12. *Kahn v. Tremont, 694 A.2d at 429*.

(n13)Footnote 13. *See Mendel v. Carroll, 651 A.2d 297, 304-06 (Del. Ch. 1994)*; *Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983)*.

(n14)Footnote 14. *See, e.g., In re Tele-Comms., Inc. S'holders Litig., (Del. Ch. Dec. 21, 2005)* (failure to specify compensation of special committee members at the outset, together with \$1 million payments to those members following approval of the transaction, raised questions as to independence of committee members).

(n15)Footnote 15. *See, e.g., Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997)* (Delaware Supreme Court noted lack of attendance and diligence by some committee members as part of the basis for its conclusion that the defendants retained the burden of showing the entire fairness of the transaction, despite the use of a special committee).

(n16)Footnote 16. An especial area of concern arises in transactions where a financial adviser furnishes a fairness opinion to a target while also providing so-called "stapled financing" to the bidder. In *Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1006 & n.46 (Del. Ch. 2005)*, the Delaware Chancery Court noted that playing such a dual role creates "the appearance of impropriety." Investment banks have developed a number of policies to address potential conflicts of interest, including declining to offer stapled financing when representing a special committee evaluating an MBO.

(n17)Footnote 17. *See* Schedule 13E-3 Item 9 and Regulation M-A Item 1015(b)(4) (requiring a description of any material relationship between the financial adviser and the issuer or their respective affiliates during the past two years or which is mutually understood to be contemplated, and of any compensation received or to be received as a result of such relationship).

(n18)Footnote 18. *See, e.g., In re Tele-Comms., Inc. S'holders Litig., (Del. Ch. Dec. 21, 2005)* (large contingency fee created serious issue of material fact as to whether financial adviser and its counsel could provide independent

advice to special committee).

(n19)Footnote 19. In *Levco Alternative Fund Ltd. v. Reader's Digest Ass'n*, 803 A.2d 428 (Del. 2002) , the Delaware Supreme Court indicated that in a transaction where the public shareholders receive different consideration from the consideration the large shareholder receives, the financial adviser's opinion should address fairness with respect to the public shareholders (rather than just with respect to the company). See also *In re Tele-Comms., Inc. S'holders Litig.*, (Del. Ch. Dec. 21, 2005) (financial adviser issued separate opinions as to each of company's two classes of stock, without express discussion of whether the relative impact of a premium paid to one class of stock was fair to holders of the other class of stock).

(n20)Footnote 20. Schedule 13E-3 Item 9; Regulation M-A Item 1015(a).

(n21)Footnote 21. See Schedule 13E-3 Items 9 and 16; Regulation M-A Items 1015(b)(6) and 1016(c).

(n22)Footnote 22. For example, the SEC staff has explained that if investment bankers made oral presentations to directors, the oral presentation should be summarized in detail in the disclosure document provided to target shareholders, and any documents, talking papers or background materials presented to the board must be filed as exhibits to the Schedule 13E-3 and summarized in the disclosure document. See SEC, Division of Corporation Finance, *Compliance and Disclosure Interpretations*, "Going Private Transactions, Exchange Act Rule 13e-3 and Schedule 13E-3," Question 117.06 (Jan. 26, 2009); *Ephraim, Charles L.*, SEC No-Action Letter, Applicability of Item 9 of Schedule 13E-3 to Certain Reports, 1987 SEC No-Act., LEXIS 2687 (Sept. 30, 1987).

(n23)Footnote 23. *In re Pure Resources S'holders Litig.*, 808 A.2d 421, 449 (Del. Ch. 2002) .

(n24)Footnote 24. *Pure Resources*, 808 A.2d at 449 .

(n25)Footnote 25. *Pure Resources*, 808 A.2d at 449 .

(n26)Footnote 26. *Pure Resources*, 808 A.2d at 449 .

(n27)Footnote 27. *Pure Resources*, 808 A.2d at 449 .

(n28)Footnote 28. See *In re The MONY Group Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004) (quoting *Pure Resources*). See also *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007) (proxy statement was materially incomplete due to failure to disclose projections used by financial adviser to perform discounted cash flow valuation supporting its fairness opinion); *In re JCC Holding Co. S'holders Litig.*, 843 A.2d 713 (Del. Ch. 2003) ; *Alidina v. Internet.com Corp.*, C.A. No. 17235-NC, 2002 Del. Ch. LEXIS 156 (Del. Ch. Nov. 6, 2002) .

(n29)Footnote 29. 924 A.2d 171 (Del. Ch. 2007) .

(n30)Footnote 30. *Netsmart*, 924 A.2d at 202-03 .

(n31)Footnote 31. *Netsmart*, 924 A.2d at 203-04 .

(n32)Footnote 32. *Netsmart*, 924 A.2d at 204 (quoting *Pure Resources*, 808 A.2d at 449).

(n33)Footnote 33. *In re CheckFree Corp. S'holders Litig.*, C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007).

(n34)Footnote 34. *CheckFree*, 2007 WL 3262188, at *2-3.

(n35)Footnote 35. *CheckFree*, 2007 WL 3262188, at *3 (emphasis in original).

(n36)Footnote 36. *CheckFree*, 2007 WL 3262188, at *3 (quoting *Netsmart*, 924 A.2d at 203).

(n37)Footnote 37. C.A. No. 1577-VCP, 2007 WL 4292024 (Del. Ch. Nov. 30, 2007).

(n38)Footnote 38. *Globis*, 2007 WL 4292024, at *12.

(n39)Footnote 39. 2007 WL 4292024, at *13 (citing *In re JCC Holding Co. S'holder Litig.*, 843 A.2d 713, 718 (Del. Ch. 2003) (finding no disclosure violation where the corporation "did not have reliable recent long-term projections from which [the bank] could perform a [discounted cash flow] valuation analysis")). In *In re BEA Systems, Inc. S'holder Litig., Cons.* C.A. No. 3298-VCL (Del. Ch. Mar. 26, 2008) (Lamb V.C., oral op.), Vice Chancellor Lamb held that Delaware law does not require disclosure documents to explain why the financial adviser did not perform and include in its final valuation materials a particular valuation analysis, such as a discounted cash flow analysis, so long as the disclosure document accurately describes the financial analyses relied upon by the financial adviser.

(n40)Footnote 40. *Simonetti Rollover IRA v. Margolis*, C.A. No. 3694-VCN, 2008 Del. Ch. LEXIS 78 (Del. Ch. June 27, 2008) .

(n41)Footnote 41. 2008 Del. Ch. LEXIS 78, at *30 (quoting *Netsmart*, 924 A.2d at 203).

(n42)Footnote 42. 2008 Del. Ch. LEXIS 78, at *30 .

(n43)Footnote 43. 2008 Del. Ch. LEXIS, at *32-33. See also *Wayne County Employees' Retirement Sys. v. Corti*, 954 A.2d 319 (Del. Ch. 2008) (the fact that certain projections were reviewed by a target's board does not in and of itself make those projections material in the absence of evidence that the board relied on them).

(n44)Footnote 44. Traditional financing conditions continue to be common in smaller or middle market transactions.

(n45)Footnote 45. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-08 (Del. 1983) .

(n46)Footnote 46. Two-step transactions formerly raised difficult issues under the "best price" requirements of Exchange Act Rule 14d-10, which generally requires that the consideration paid to any security holder pursuant to a tender offer be equal to the highest consideration paid to any other security holder during that tender offer. Tender offers often were not used in going private transactions because of concerns about Rule 14d-10 claims where, for example, the transaction involved a management rollover of equity into a new vehicle formed to take the target company private, or where in connection with the transaction severance or other benefits were granted to the target company's managers who were also stockholders. However, the SEC amended Rule 14d-10 in 2006 to add, among other things, a specific exemption for consideration paid pursuant to employment compensation, severance or other employee benefit arrangements. The SEC also added a safe harbor protecting compensatory arrangements approved by an independent compensation committee or comparable body.

(n47)Footnote 47. See *In re Pure Resources S'holders Litig.*, 808 A.2d 421, 445-446 (Del. Ch. 2002) .

(n48)Footnote 48. Delaware Vice Chancellor Leo Strine has observed that "the absence of any additional standard of review-affecting benefit for a Minority Approval Condition, has made the use of that independent, and functionally distinct, mechanism less prevalent" and that accepting this condition adds "an element of transactional risk without much liability-insulating compensation in exchange." *In re Cox Communs., Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005) .

(n49)Footnote 49. On the other hand, it is possible for the market to misjudge the dynamics of the situation and for the price of the target company's stock to trade above the price that the large shareholder is willing to pay and that the special committee would otherwise be willing to accept, which can make it harder for the parties to come to an

agreement.

(n50)Footnote 50. *Paramount*, 637 A.2d at 44. See also *In re The MONY Group Inc. S'holder Litig.*, 852 A.2d 9, 19 (Del. Ch. 2004) (noting that Revlon "does not demand that every change in control of a Delaware corporation be preceded by a heated bidding contest," but rather that the "directors must act in accordance with their fundamental duties of care and loyalty" (quoting *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989))).

(n51)Footnote 51. *Paramount*, 637 A.2d at 44. See also *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. Mar. 14, 2007) (noting that the "no single blueprint' mantra" is not a "one-way principle" and that the mere fact that a technique was successfully used by other boards in different market circumstances does not mean that it is reasonable in other circumstances that "involve very different market dynamics").

(n52)Footnote 52. See, e.g., *In re Fort Howard Corp. S'holders Litig., No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988)*, appeal refused, 547 A.2d 633 (Del. 1988); *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279 (Del. 1989); *In re Pennaco Energy, Inc. S'holders Litig.*, C. A. No. 18606, 2001 WL 115341 (Del. Ch. Feb. 5, 2001); *In re The MONY Group Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004); *In re Toys "R"Us, Inc. S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005); cf. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989).

(n53)Footnote 53. See Franci J. Blassberg & Stefan P. Stauder, *Shop Till You Drop*, Debevoise & Plimpton Private Equity Report, Fall 2006, at 1. In *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007), the Delaware Chancery Court found that the Netsmart board of directors breached its Revlon duties in connection with a going-private transaction by limiting the potential buyers to private equity firms and failing to explore interest from strategic buyers. See also *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007) (questioning efficacy of 45-day go-shop period where competing bidder required to reach definitive agreement during that period). *But cf. In re Topps Co. S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007) (upholding a 40-day go-shop period). See § 12.05[3], *supra*, for a discussion of the *Netsmart*, *Topps* and *Lear* decisions.

(n54)Footnote 54. See, e.g., *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007) (2.8% go-shop termination fee and 3.5% post-go-shop termination fee); *In re Topps Co. S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007) (3% go-shop termination fee and 4.6% post-go-shop termination fee).

(n55)Footnote 55. See *Kahn v. Tremont Corp.*, 694 A.2d at 429. See also *In re Maxxam, Inc.*, C.A. 12111, 12353, 1997 Del. Ch. LEXIS 51, *91-92 (Apr. 4, 1997) (burden not shifted where, among other things, special committee failed to gain concessions in the bargaining process).

(n56)Footnote 56. See *Creo, Inc. v. Printcafe Software, Inc.*, No. 20164 (Del. Ch. Feb. 21, 2003) (refusing to enjoin the adoption by the board of a target company of a poison pill that prevented a 45% shareholder from exercising an existing option to increase its interest to 54%, or from granting to a competing bidder a 19.9% option). Cf. *In re Topps Co. S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007) (enjoining merger until target waives standstill provision to enable competing bidder to make tender offer at higher price and communicate with shareholders about its version of events).

(n57)Footnote 57. In *Kahn v. Lynch*, in concluding that the burden of proof rested with the defendants, the court noted that the controlling shareholder had indicated its willingness to proceed with a tender offer at a lower price if the special committee did not approve the controlling shareholder's proposed transaction. The Delaware Supreme Court later upheld a lower court's conclusion that the defendants had shown the transaction was entirely fair in part because the record showed negotiation upwards of the price, and the opinions of two investment bankers as to fairness. See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1119 (Del. 1994). See also *American Gen. Corp. v. Texas Air Corp.*, C.A. 8390, 1987 Del. Ch. LEXIS 382 (Del. Ch. Feb. 5, 1987) (burden of proof did not shift to the plaintiff when the committee was told that if it did not accept the parent's final offer, the parent would proceed with the transaction nevertheless).

(n58)Footnote 58. *Kahn v. Lynch*, 638 A.2d at 1119 (quoting *In re First Boston, Inc. S'holders Litig.*, C.A. 10338, 1990 Del. Ch. LEXIS 74, at *20-21 (Del. Ch. June 7, 1990) .

(n59)Footnote 59. See Del. Gen. Corp. L. § 170 (permissible sources for payment of dividends); § 174 (liability of directors for improper dividends).

(n60)Footnote 60. 924 A.2d 171 (Del. Ch. 2007) .

(n61)Footnote 61. 926 A.2d 58 (Del. Ch. 2007) .

(n62)Footnote 62. 926 A.2d 94 (Del. Ch. 2007) .

(n63)Footnote 63. See, e.g., *Joseph v. Shell Oil Co.*, 482 A.2d 335, 339 (Del. Ch. 1984) .

(n64)Footnote 64. See *Joseph*, 482 A.2d at 339 (enjoining tender offer because controlling shareholder had not made full disclosure of all relevant information). See also *In re Pure Resources S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002) (enjoining a tender offer because disclosure documents provided to minority shareholders failed to make materially complete and accurate disclosure). Cf. *In re Siliconix Inc. S'holders Litig.*, CA 18700, 2001 Del. Ch. LEXIS 83 (June 19, 2001) (declining to enjoin tender offer because there were no disclosure violations and tender offer was not coercive).

(n65)Footnote 65. See, e.g., Del. Gen. Corp. L. § 262 (appraisal rights).

(n66)Footnote 66. *Gilliland v. Motorola*, 859 A.2d 80, 87 (Del. Ch. 2004) , citing *Zirn v. VLI Corp.*, 681 A.2d 1050 (Del. 1996) .

(n67)Footnote 67. *Gilliland*, 859 A.2d at 81 .

(n68)Footnote 68. Delaware Vice Chancellor Strine has criticized this practice, observing that "complaints attacking negotiable proposals are not meritorious and do not give rise to a presumptive claim to a fee". See *In re Cox Communs., Inc. S'holders Litig.*, (June 6, 2005), 879 A.2d 604 .

(n69)Footnote 69. In *In re SS&C Techs. S'holders Litig.*, 911 A.2d 816 (Del. Ch. 2006) , the Delaware Court of Chancery declined to approve a proposed settlement of a stockholder class action challenging an MBO because, among other things, the settlement agreement was brought before the court nearly ten months after the transaction closed. The court pointed out that it is "imperative to present settlements for approval before the terms of the settlement are performed" and explained that where a settlement of a lawsuit challenging a pending transaction is reached before the transaction is completed and involves a change in transaction terms, court approval of the settlement should, where possible, occur before the transaction closes. *SS&C Techs.*, 911 A.2d at 817. Where circumstances warrant closing the transaction prior to obtaining court approval of the settlement, at a minimum, leave of court should be obtained for presenting the settlement for approval after closing, and the settlement should be presented to the court promptly after the transaction is consummated. The court concluded that, as a result of the earlier performance of the settlement "consideration" (which consisted entirely of the publication of supplemental disclosure) followed by the closing of the transaction, the court's review of the settlement terms was "substantially emptied of meaning or purpose." *SS&C Techs.*, 911 A.2d at 817. The court noted that "there is simply little to commend the process of weighing the merits of a 'settlement' of litigation where the only continuing interest is that of the plaintiffs' counsel in recovering a fee." *SS&C Techs.*, 911 A.2d at 818.

(n70)Footnote 70. In *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171, 191 (Del. Ch. 2007) , Vice Chancellor Strine observed that the "tardy, omnibus consideration of meeting minutes is, to state the obvious, not confidence-inspiring," particularly when coupled with the absence of minutes for at least one meeting.



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Corporate Governance: Law and Practice

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CHAPTER 12 GOVERNANCE IN THE CORPORATE CONTROL CONTEXT

1-12 Corporate Governance: Law and Practice § 12.11

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§ 12.11 Preparing in Advance for Hostile Tender Offers**[1] Introduction**

Tender offers can move extraordinarily fast. There is often no time for leisurely contemplation of strategic alternatives. Immediate action and reaction are the orders of the day. Because the target may have very little time for organization and planning once a hostile bidder announces an unsolicited tender offer, advance preparation is essential. The target must remember, however, to conform its ultimate responses to the specific circumstances of a particular offer.

This section discusses the principal elements of a program of preparation for a hostile tender offer, including the preparation of the target's officers and directors, the possible amendment of the target's certificate of incorporation and bylaws, and the adoption of a shareholder rights plan (or "poison pill") and other potentially useful measures to assure that the target will be in the best position to evaluate a tender offer and to respond appropriately, should the target's directors determine that the offer is not in the best interests of the company's shareholders.

[2] Preparation of Directors and Officers

The target's directors should become familiar with their responsibilities in the event of a tender offer. Periodic presentations by the company's advisers are useful to familiarize the directors as to their obligations in the event of an offer, and as to developments in mergers and acquisitions law and practice. It is also helpful to review with the board the defensive provisions available to assist the directors in discharging their fiduciary responsibilities should an unsolicited offer be made for the company.

Moreover, it is appropriate to remind the directors that it is permissible for a healthy company to have a policy of continuing as an independent entity, and that there is no obligation to follow up on preliminary inquiries, although the board is obliged to consider formal offers for the company. It is important to review in general with the board how the

company, through its officers, proposes to respond to inquiries with respect to possible acquisition transactions. This enables the target's CEO to tell an inquirer that the topic has been discussed with the board, and that the company's policy is not to encourage takeover discussions and to continue as an independent entity.

A bidder may seek to sound out in advance the attitudes of the directors of a prospective target company to acquisitions. The directors should report all inquiries in this area, however informal, to a central person--usually the CEO. This is important for two reasons. First, it is important that the company speak with one voice, through a single spokesperson. Second, if "nibbles" are reported to a central person, tidbits of information, meaningless individually, may in the aggregate form a mosaic from which an intelligible pattern can become visible.

If the company's policy is not to encourage takeover discussions, the directors should be careful not to give a misleading impression of willingness to pursue unsolicited takeover discussions to inquirers. For example, if an investment banker or another company asks a director whether the company might be interested in pursuing takeover discussions, a response such as: "It all depends on the price" or "Sure, we'd certainly consider it" might be read as inviting a takeover inquiry.

If the company has a policy of not encouraging unsolicited takeover inquiries, a better response might be: "We believe strongly in our future as an independent company, and we're definitely not looking to be acquired." Such a response, like the similar possible responses discussed below, does not preclude (1) a potential acquiror from submitting an offer, nor (2) the board of directors from considering carefully an offer if one were to be made. If an inquirer persists, it should also be made clear that all acquisition discussions must be with the CEO. The CEO, in turn, should keep the board informed of all substantial inquiries.

[3] Pre-Tender Offer Defensive Measures

In addition to preparing its directors and officers for future hostile tender offers, a potential target can take a number of defensive measures that will better prepare it to respond to such offers. The target should consider these measures before a hostile tender offer is launched against it.

[a] Charter Amendments

A potential target might make itself less attractive to corporate raiders by amending its charter in such a way as to make it more difficult for a hostile acquiror to change control of the target even after purchasing a majority of the target's shares. Such charter amendments could include:

- Classification of the board of directors, so that the whole board is not up for election in any one year. This can have the effect of delaying the time within which a bidder could obtain effective control of the board.
- Requiring a supermajority vote on a merger with someone who owned more than a specified percentage of the company's stock, unless the transaction had been approved by the board before the threshold had been crossed or unless fair price tests have been met.
- Eliminating the ability of shareholders to act by written consent, rather than only at an annual or special meeting of shareholders.
- Restricting the ability of shareholders to call a special meeting of shareholders.
- Authorizing "blank check preferred"--that is, preferred stock issuable in series, the terms of which can be fixed by the directors without a shareholder vote. A new series of preferred stock could be used to

underlie a poison pill or, subject to compliance with requirements under stock exchange rules and applicable law, could be issued to a favored minority investor.

- Requiring a supermajority vote before shareholders can amend the bylaws.
- Prohibiting "greenmail"--that is, the payment of a significant premium over market price to repurchase shares from a significant shareholder of the company, absent approval by the company's shareholders.
- Authorizing the board to consider non-economic factors--for example, the impact of a proposed acquisition not only on shareholders but also on employees, customers, suppliers and the communities in which the company's facilities are located--in evaluating a takeover bid.

None of these "shark repellents" is a "showstopper"; indeed, many hostile takeovers in recent years have involved targets whose charters have contained many of the provisions discussed above. Nevertheless, shark repellents may have some deterrent effect, particularly against smaller, ill-financed bidders.

In submitting such charter amendments for shareholder approval, management must take care to disclose the effects that the amendments might have. Specifically, the SEC requires a company that is proposing a defensive charter amendment to spell out the overall effects of the amendment and also to describe other antitakeover provisions applicable to the company.ⁿ¹ Moreover, the adoption of certain provisions, such as board classification and supermajority voting, can affect corporate governance even absent a takeover bid.

Before proposing any charter amendments, the company should carefully evaluate the likelihood that the shareholders will vote to adopt them. Most institutional investors tend to vote against charter amendments that they perceive as creating an impediment to an acquisition of a company. Proxy advisory firms tend to recommend that their clients vote against such amendments. A proxy solicitation firm can assist in assessing particular institutional investors' and advisory firms' likely reaction to particular proposed amendments. Proposals that are not adopted could send signals to potential acquirors that the company's shareholders might look sympathetically upon an acquisition proposal. The company also should remember that a number of these amendments, while discouraging unsolicited tender offers, might also reduce the board's flexibility to act in the aftermath of a tender offer.

In addition, even if the company is able to adopt such a charter amendment, the company should bear in mind that the amendment may irritate some institutional investors and precipitate a future stockholder proposal requesting the directors to eliminate the amendment. If the stockholders support such a proposal and the directors do not eliminate the amendment, that would increase the likelihood that stockholders will withhold authority to elect directors--which, if the SEC's proposed rule for stockholder nominations of directors were to be adopted, would in turn increase the likelihood of a stockholder-nominated director candidate in the company's proxy statement.ⁿ²

A potential target incorporated in a state that does not permit certain defensive charter amendments might consider reincorporating itself in a state with more flexible corporate laws, such as Delaware. The company should be aware, however, that, although Delaware law grants the target's board great leeway in responding to a hostile bid, it also might increase the target's vulnerability to a takeover attempt unless the target adopts protective charter amendments.

The famous Bendix-Martin Marietta battle illustrates the difficulties that an unprotected target can experience under Delaware law: the hostile bidder, Bendix, was vulnerable to a counter-offer by the target, Martin Marietta, because Bendix's charter (and applicable Delaware law) permitted the holder of a majority of Bendix's shares to take immediate action by written consent, without having to call a shareholders' meeting. Such action was not possible under Maryland law, however, with respect to Marietta. Thus, Marietta would find it easier to gain control over Bendix than would Bendix over Marietta. A comparable result was obtained in the 1999 fight between Shorewood and Chesapeake, in

which Shorewood, the initial maker of a unsolicited proposal to acquire Chesapeake, found itself vulnerable to a counteroffer by Chesapeake because Shorewood was more vulnerable to a consent solicitation, which was not possible under Virginia law, the law applicable to Chesapeake.ⁿ³

[b] Bylaw Amendments

If the company's bylaws permit the board of directors to amend the bylaws without obtaining shareholder approval, the board might consider inserting "shark repellent" amendments in the bylaws, without going through the more elaborate process of amending the certificate of incorporation (which requires shareholder approval). The company must bear in mind that state corporation law often provides that shareholders always are free to amend bylaws.ⁿ⁴ Accordingly, the company might wish to propose a charter amendment requiring a supermajority vote of shareholders to amend the bylaws.

Possible bylaw amendments (if permitted by applicable state law) might include the following:

- *Calling of special meetings.* The company might wish to make clear that shareholders do not have the power to call a special meeting of shareholders, by providing in the bylaws that special meetings are to be called only by directors or officers--for example, by the CEO or by the secretary at the request of a majority of the board of directors.ⁿ⁵ This limitation would increase the difficulty of waging a proxy fight against management or of taking control of the company with less than a majority of shares. If such an amendment was coupled with a charter amendment requiring written consent of all of the company's shareholders in order to take action without a meeting, a would-be acquiror would find it difficult to change the composition of the board promptly and to assert effective control even after acquiring a majority of the company's shares.

- *Notice of shareholders' proposals.* The company could amend the bylaws to require that any shareholder who wishes to bring any business before a meeting must give written notice of the matter at issue within a reasonable period (*e.g.*, 90-120 days) before that meeting. A similar provision could apply to shareholder nominees for election as directors. These amendments might help the company in dealing with a large, aggressive shareholder or, at least, would limit the time during which the company would be exposed to a proxy fight. The provisions also could help to ensure that shareholders would hear both sides (and not just the bidder's arguments) before voting.

In *In re Gaylord Container Corp. S'holders Litig.*,ⁿ⁶ Gaylord's board adopted various defensive measures, including an advance notice bylaw under which a shareholder was required to make nominations at least 60 days in advance of the meeting. The court said this provision "merely lengthens the electoral contest in a way that appears to strike a reasonable balance between the electorate's need to hear out all participants in the debate and the acquiror's need for an adequate opportunity to line up a slate before the meeting."ⁿ⁷

- *Consent procedure.* If the bylaws authorize the board to establish a record date for such business as the taking of actions by written consent, the board could amend the bylaws to require that any shareholder desiring to act by consent notify the board and request the board to set a record date. The amendment then could require the board to set a record date that would give management a reasonable opportunity to react to the proposed transaction and, if desirable, to solicit proxies in opposition. A related amendment could fix a date (*e.g.*, 30 days after the mailing of proxy materials) for determining whether the proposed action received the approval of a majority of shares. Bylaws relating to consent procedures must be reasonable.ⁿ⁸

Under Section 213(b) of the Delaware corporation statute, if the board has not established a record date and no prior action by the board is required by the Delaware corporation statute, the record date for determining stockholders entitled to consent is the first date on which a signed written consent setting forth the action is delivered to the corporation. Thus, a significant minority shareholder might be able to solicit consents and then spring a *fait accompli* on the board, which would have no time to solicit opposing proxies.

[c] Structural Changes

Before confronting an unwanted tender offer, a potential target might consider a number of possible changes in the company's structure that either would make the company less attractive to raiders or would put the company in a better position to resist an offer that it determines not to be in the best interests of the shareholders. These structural changes might include placing "crown jewels"--the company's most desirable assets--in freestanding subsidiaries, to facilitate their rapid sale or spin-off; insuring that indentures and loan agreements do not restrict spin-offs, self-tender offers, or recapitalizations; developing a plan of liquidation; arranging for adequate financing to permit reverse tender offers, preemptive strikes against raiders, and self-tender offers; implementing a program for periodic repurchases of company stock; issuing company stock to a "white squire" (a friendly third party) or an employee stock option plan; effecting a leveraged buyout; recapitalizing the company to increase the debt-to-equity ratio; creating two classes of stock, one with higher voting rights (but restrictions on transfer), the other with lower voting rights (but freely tradeable); and adopting "golden parachutes" for top management. The implementation of these and other structural defenses before a raider strikes may assist the board in establishing that it approved the measures after careful consideration consistent with the directors' fiduciary obligations to the shareholders.

[d] Poison Pills

A potential target might also elect to adopt a "poison pill" to deter unwanted tender offers. Poison pills, which have become one of the most effective defensive techniques, are intended to encourage bidders to seek board approval before acquiring more than a specified percentage of a target's stock, by causing substantial dilution to the bidder if it crosses the relevant threshold without such prior approval. While the pills may tend to discourage bidders from proposing weak offers, they do not operate as a total bar to takeovers--and are not intended to do so.

Poison pills come in different packages but contain essentially similar toxins. The most common form of pill is a "call" plan, pursuant to which a company declares to shareholders a dividend of a right to buy (or "call") shares of the issuer. An example illustrates how call plans work.

Assume a target with 10,000,000 shares of outstanding common stock that trade at \$25 per share. The target may choose to distribute one right for every share of outstanding common stock. The distribution is effected as a dividend, without shareholder approval. Each right entitles the holder to purchase a share of common (or of a new series of preferred designed to resemble common stock) for \$75 per share. The rights trade with the common shares and are not initially exercisable; indeed, no one would even wish to exercise a right to pay \$75 for shares trading at \$25. Thus, the rights presumably have no present market value, and each unit of common-plus-right probably is worth only \$25.

The toxic feature of the pill, however, lies elsewhere. In the event that a hostile tender offer is announced, the purchase rights become detachable from the common shares. If the bidder acquires more than a threshold amount (typically in the range of 10 to 20 percent) of the target's stock, the typical rights agreement requires that the rights held by the bidder automatically become void, and that every other holder of an outstanding right thereafter be entitled to purchase, say, \$150 worth of the target's stock for \$75. The offer or thus would suffer severe dilution if it bought more than the triggering amount of the target's stock.

The rights issuer's board retains control of the poison through its authority to redeem the rights for a nominal amount (*e.g.*, one cent per right) typically until (or for a limited period of time after) someone acquires at least the threshold

percentage of the target's stock and through its authority to amend the plan. It is this redemption and amendment power that encourages the bidder to negotiate with the board.

With a pill in place, the takeover scenario might play out as follows. A bidder might offer to effect a friendly merger with the target, paying \$300,000,000 (or \$30 per share) to buy the 10,000,000 outstanding shares currently trading at \$25 per share. If the target's board rebuffs the bidder's friendly overtures, the bidder must decide whether to pursue a hostile tender offer, in which case it would have to address the rights that would become detachable from the common shares soon after the launching of that hostile offer.

The bidder might attempt to negate the rights by making its tender offer for both common stock and rights and by conditioning its obligation to purchase *any* securities on the tender of, for example, at least 95 percent of the rights. The problem with this approach, however, is obvious: every rights holder will know that, upon a subsequent merger, his right will be worth far more than he would be paid for it up front, during the tender offer; he therefore will have a strong incentive to withhold his rights, hoping--probably in vain--that other, less calculating holders will tender sufficient rights to satisfy the bidder's minimum. It is a classic "prisoner's dilemma."

The bidder also could condition its tender offer on elimination of the rights, either through redemption by the target's board or through judicial invalidation. If the target's board has not come up with better alternatives for shareholders as the end of the tender offer approaches, and if most shareholders have shown their approval of the offer by tendering their shares, the target's directors may be under heavy pressure to redeem the rights. Failure to do so may expose the directors to shareholder suits if the bidder withdraws its offer and the price of the target's stock falls back to its pre-bid levels.

Alternatively, the bidder could seek to replace the board of directors of the target with a slate of new directors who would be receptive to dismantling the pill to facilitate the bidder's offer, in the absence of a better offer. If, however, the target has a staggered board, this could not be done in one fell swoop. Conceivably, a court could invalidate the rights plan if it contains unusual features or the court could order the board to redeem the rights or make them inapplicable to the tender offer--although such injunctions are rare.

Users (and victims) of poison pills should realize, however, that pills tend not to be "showstoppers," guaranteed to scare away or defeat hostile offerors. Rather, pills far more often constitute negotiating tools that the target may be able to use to obtain better offers.⁹

Legal Topics:

For related research and practice materials, see the following legal topics:
Mergers & Acquisitions Law Takeovers & Tender Offers

FOOTNOTES:

(n1)Footnote 1. SEC Release No. 34-15,230, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,748, at 80,986-88 (Oct. 13, 1978).

(n2)Footnote 2. Proposed rule 14a-11. *See SEC Release No. 34-48626, Fed. Sec. L. Rep. (CCH) P 87,101* . (Oct. 14, 2003).

(n3)Footnote 3. *See Chesapeake v. Shore, CA 17626, 771 A.2d 293, 2000 Del. Ch. LEXIS 20 (Feb.7, 2000)* .

(n4)Footnote 4. *See, e.g., Del. Gen. Corp. L. § 109(a)* (even if the certificate of incorporation confers power to adopt or amend bylaws upon the directors, that does not divest the stockholders of their power to adopt or amend bylaws).

(n5)Footnote 5. *See* Del. Gen. Corp. L. § 211(d) (special meetings of stockholders may be called by the board of directors or by such person or persons as may be authorized by the certificate of incorporation or by the bylaws).

(n6)Footnote 6. *In re Gaylord Container Corp. S'holders Litig*, 753 A.2d 462 (Del. Ch. 2000) .

(n7)Footnote 7. *Gaylord*, 753 A.2d at 482 .

(n8)Footnote 8. "In evaluating the reasonableness of a bylaw, which purports to establish ministerial review of the validity of consents, several factors are relevant. First, a court must determine the purpose sought to be served. A bylaw whose real purpose is delay of shareholder action is per se unreasonable. Second, the court should consider the impact of the bylaw upon the effective exercise of the power conferred under Section 228. Finally, the bylaw should contain only the minimal requisites for a reliable and prompt ministerial review to ensure the orderly function of corporate democracy. Such ministerial review must not be unduly elaborate, should contain reasonable time periods only necessary to the circumstances, and should be one which, when administered in good faith, is reasonable and balanced." *Allen v. Prime Computer, Inc.*, 540 A.2d 417, 420 (Del. 1988) . For an example of one bylaw relating to consent procedures that was upheld by the Delaware Chancery Court, *see* *Edelman v. Authorized Distribution Network*, CA 11104, 1989 Del. Ch. LEXIS 156 (Nov. 3, 1989) .

(n9)Footnote 9. While a rights plan can be adopted by the board without stockholder approval, the board should bear in mind that adopting a poison pill may irritate institutional investors--particularly if the pill is not used to explore value-maximizing alternatives--and could in the future lead to stockholder proposals to redeem the pill. RiskMetrics Group (formerly Institutional Shareholder Services (ISS)), a leading proxy voting advisory service, has a policy of recommending that its clients withhold authority to vote for directors of any company that adopts a poison pill without shareholder approval, does not put the pill to a vote at the current annual meeting and does not require the pill to be put to a vote within 12 months of its adoption.



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Appendix 12-A: Model Board Resolutions Establishing a Special Committee

1-12-A Corporate Governance: Law and Practice Appendix 12-A:.syn

§ 12-A.syn Synopsis to Appendix 12-A: Model Board Resolutions Establishing a Special Committee

[12-A] Model Board Resolutions Establishing a Special Committee



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Appendix 12-A: Model Board Resolutions Establishing a Special Committee

1-12-A Corporate Governance: Law and Practice [12-A]

[12-A] Model Board Resolutions Establishing a Special Committee

RESOLVED, that [Names of Directors of the Special Committee] are hereby appointed as a Special Committee (the "Committee") of the Board, with the power to select their own chairperson, if they so desire, and with full power and authority (i) to consider any proposal (in its initial form or as the same may be modified, the "Proposal") from [Name of the Purchaser], (ii) to consider whatever action with respect to the Proposal may be appropriate in the best interests of the Company, including without limitation whether the transaction contemplated in the Proposal should be consummated and whether the terms and conditions of the Proposal should be modified, and to negotiate with the prospective purchaser with respect to any such modification as the Committee may deem appropriate or desirable, (iii) to consider and negotiate with respect to any alternatives to the Proposal as the Committee believes to be available and in the best interests of the Company and (iv) to report back to the Board its conclusions and recommendations.

RESOLVED, that the Committee is authorized to retain, at the expense of the Company, financial advisers, legal counsel, accountants and other advisers as it deems appropriate to advise the Committee and to assist it in discharging its responsibilities, and to enter into engagement letters with such advisers and counsel on such terms as the Committee deems advisable.

RESOLVED, that the officers, employees and agents of the Company are directed to provide to the Committee and its advisers all such information, documents and assistance as they may request, and to cooperate with the Committee and its advisers in all respects.

RESOLVED, that, in consideration of their service on the Committee with respect to the matters set forth in these resolutions and the significant time commitment that such service will entail, the Company will (i) pay each member of the Committee a fee of \$_____, (ii) indemnify and hold harmless each member of the Committee against any and all liabilities and expense (including without limitation legal fees and expenses) arising in connection with such service, heretofore or hereafter rendered, to the fullest extent permitted by the Company's Certificate of Incorporation and Bylaws, as in effect on the date hereof, and (iii) reimburse each member of the Committee for all out-of-pocket travel and other expenses incurred in connection with the member's service on the Committee.

RESOLVED, that the Committee be, and hereby is, authorized to adopt such procedures concerning its operations as it deems necessary or appropriate.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice 13.syn

AUTHOR: Jay M. Cohen

§ 13.syn Synopsis to Chapter 13: COMPLIANCE AND THE CODE OF CONDUCT

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§ 13.02 Legal and Regulatory Background

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[ii] Purpose and Structure--The "Carrot and Stick"

[iii] Definition of an "Effective" Compliance Program in the 1991 Guidelines

[iv] The November 2004 Amendments to the FSGO

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[c] Caremark and Related Cases

- [i] The Caremark Case
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- [d] The Government's View of Codes of Conduct--Compliance Guidance for Health-Care Companies
 - [i] OIG Compliance Guidance--General
- [e] Compliance Perspectives of Other Agencies
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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.01

AUTHOR: Jay M. Cohen

§ 13.01 The Code of Conduct

Mandates in the Sarbanes-Oxley Act of 2002ⁿ¹ (the "Sarbanes-Oxley Act" or "Sarbanes-Oxley") and related regulations have made the code of conduct a required element of an organization's overall program for communicating and fulfilling its commitment to ethics, integrity, and compliance with laws and regulations. Moreover, in deciding whether to pursue settling securities fraud and other cases, or on what terms to settle them, regulatory and enforcement agencies consider, among other factors, whether companies have adopted and used reasonable efforts to enforce codes of conduct. In this chapter, we will analyze the legal, regulatory and "best practice" requirements for codes of conduct and offer some practical advice on how to best implement them.

We also will review more than two decades of efforts, in addition to the Sarbanes-Oxley Act, to develop, implement and enhance standards for organizational codes of conduct. These initiatives—from government, private industry and interest groups—are worth examining for several reasons.

First, these efforts have defined the substance and goals of organizational compliance programs and the role of codes of conduct within such programs. In the process, they have contributed to the widespread recognition of the code as an indispensable means of promoting organizational integrity.

Second, these initiatives offer a large body of information regarding what works in the design, implementation and enforcement of organizational codes of conduct. This practical experience can assist organizations in meeting the more recent mandates and in ensuring that their codes have a demonstrable, positive impact on organizational behavior.

This is a critical point for compliance officers and corporate counsel considering how best to develop or improve their organizations' codes of conduct. After all, a number of companies caught up in scandals and misconduct had codes of conduct, but those documents were not taken seriously enough. For example, the Enron Board of Directors approved three separate waivers of the conflicts of interest provisions in its code of conduct when it allowed the chief financial officer to have large, personal financial interests in entities doing business with the company and then to profit at the company's expense. As summarized by the report of an investigative committee of the United States Senate, "the Enron Board's decision to waive the company's code of conduct and allow its Chief Financial Officer ("CFO") to establish and operate off-the-books entities designed to transact business with Enron was also highly unusual and disturbing." The

refusal to enforce the code of conduct contributed to the collapse of the company and the defrauding of shareholders, because "hundreds of millions of dollars that should have stayed with Enron shareholders instead lined the pockets" of the CFO and other investors in these entities.ⁿ²

It is not sufficient to have a code of conduct on paper, even one that on its face meets all of the legal requirements, if that code is not understood, respected and followed, from the top of the organization on down. The practical information we will review can help organizations ensure that their codes receive the required attention and respect.

The third reason to examine the history of codes of conduct is that, in several instances, regulators, prosecutors and courts have articulated their expectations for codes of conduct, as well as the possible advantages to organizations of having and enforcing a suitable code of conduct. These expectations and advantages continue to this day and, if anything, have grown as the result of the regulatory responses to the many scandals of this millennium.

Fourth, these experiences have guided Congress, the Securities and Exchange Commission (the "SEC") and the stock exchanges in their decisions about the specific elements to require for codes in the Sarbanes-Oxley Act and related regulations. Indeed, more recent mandates were informed by-and in many cases taken directly from-these efforts.

There is remarkable consistency in the structure and substance of the codes of conduct that we will review from throughout this period; what has changed is that mandates for codes have now spread from highly-regulated industries such as defense and health care to a far broader universe of companies. This structure and substance offers a useful and practical guide for the on-going development and effective application of the code of conduct in any organization.

Our fifth goal for this chapter is to place the regulatory and practical development of the organizational code of conduct in the context of another element that has emerged from scandals: the focus on the organization's "culture of compliance" in addition to its compliance structure and process. We will examine what it means to have such a culture, at least according to the regulators; how to promote and encourage this culture; and some ways of determining if these efforts are succeeding in an organization.

Reactions to the financial crisis that began in 2007 have demonstrated that--despite what many have expected and some may have hoped--the intense focus by regulators, prosecutors and the public on corporate integrity will not change anytime soon. If anything, criticism of the SEC and other regulators for failing to properly investigate the Madoff Ponzi scheme and other frauds ensures that this pressure will only intensify.

For any organization to succeed in this challenging environment, it is essential to have a corporate code of conduct that is comprehensive, realistic, and consistently enforced. The choice corporations have is to do it on their own terms or, as companies that run afoul of regulations and regulators continue to learn, be forced to strengthen their compliance programs and controls as part of a costly settlement and subject to the supervision of the government.ⁿ³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. The Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C).

(n2)Footnote 2. *See* The Role of the Board of Directors in Enron's Collapse, S. Rep. No. 107-70 (2002), at 24, 38.

(n3)Footnote 3. *See, e.g.*, Nortel Networks Pays \$35 Million to Settle Financial Fraud Charges, SEC Litigation Release No. 20333, October 15, 2007, *available at* www.sec.gov.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.02

AUTHOR: Jay M. Cohen

§ 13.02 Legal and Regulatory Background

[1] Goals of Organizational Compliance Programs and Codes of Conduct

Organizational compliance programs are designed to accomplish two fundamental goals. First, they seek to prevent, detect and appropriately respond to violations of laws, regulations, and company policies and, in the process, to promote ethical behavior within the organization. In so doing, these programs strive to lessen the likelihood that the organization or its individual employees will fail to meet legal and regulatory obligations and commitments to customers, fellow employees, shareholders and other stakeholders. Compliance programs with codes of conduct accomplish this by making sure that employees know what these obligations and commitments are and by giving them avenues (such as confidential hotlines) to ask questions or report concerns. These programs also can minimize adverse consequences and prevent small problems from becoming more serious ones, by identifying and detecting problems quickly.

Second, a carefully-organized and consistently-enforced compliance program can enable a company to limit or even avoid corporate liability for the compliance failures of individual employees. A corporate compliance program that includes a code of conduct will not absolutely "immunize the corporation from liability when its employees, acting within the scope of their authority, fail to comply with the law."¹ Nevertheless, even if it does not stop every instance of corporate wrongdoing by errant employees, a well-designed and consistently enforced code of conduct makes the organization look less culpable in the eyes of regulators and prosecutors.

Thus, there are at least three compelling reasons for companies to have and to enforce a strong code of conduct. First, legal mandates for such codes are reaching more organizations and becoming increasingly prescriptive. In this regard, for example, the Sarbanes-Oxley Act of 2002 and the regulations thereunder mandate that public companies (1) either (a) adopt codes of conduct applicable to their principal executive officers, principal financial officers, principal accounting officer or controller, or persons performing similar functions, or (b) disclose why they have not done so, and (2) disclose any waivers or amendments of such codes in a current report on SEC Form 8-K.² Second, regulators often expect regulated entities to have comprehensive codes of conduct, even when the law does not explicitly require it. Third, having and enforcing a code of conduct can prevent or limit the legal and regulatory consequences for the organization of wrongdoing by errant employees.

The common elements of compliance programs have been defined by the developments discussed below. One common element is the code of conduct. A code of conduct contributes to the objectives of organizational compliance programs by emphasizing senior management's commitment to compliance and then informing employees about the organization's fundamental principles and values; its key compliance issues, regulations and standards; the resources available to help employees understand and meet these values and standards; and the means of monitoring and enforcing them.

[2] Key Events in the Development of Organizational Codes of Conduct

[a] Defense Industry Initiative

[i] *The Packer Commission*

The defense industry was one of the first to adopt the code of conduct as an essential element of a comprehensive program to prevent corporate misconduct. Much like today, it did so in the face of scandals and at the prodding of the government. In 1985, President Reagan appointed the President's Blue Ribbon Commission on Defense Management (the "Packer Commission"), following a number of reported instances of fraud or waste in defense procurement in the mid-1980s. The Packer Commission concluded that the defense contracting process, and public confidence in the defense industry, would benefit from better corporate self-governance. In its Interim Report dated February 28, 1986, the Packer Commission stated:

To assure that their houses are in order, defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance.ⁿ³

[ii] *The Defense Industry Initiative Principles*

In response to this report, a number of defense contractors met in the spring of 1986 and founded the Defense Industry Initiative on Business Ethics and Conduct ("DII"). The goals were "to create a heightened level of ethical conduct 'from the board room to the mail room' in every company in the defense industry" and to "promote self-governance as a means of confirming management's commitment to abide by ethical standards."ⁿ⁴

The DII continues to the present, and as of the end of 2008, 90 companies, representing the largest defense contractors as well as a number of smaller companies, were signatories to its compact.ⁿ⁵ These companies have all agreed to adopt the six DII principles, which require that each member company:

- (1) adopt and adhere to a written code of conduct;
- (2) train employees about the code, which "establishes the high values expected of employees and the standards by which they must judge their own conduct and that of their organization";
- (3) encourage internal reporting by employees of violations of the code, without fear of retribution;
- (4) implement systems to monitor compliance with the code and with federal procurement laws, and to provide for voluntary disclosure of violations;
- (5) share "best practices" with other firms in order to "preserve the integrity" of the industry; and
- (6) be accountable to the public through public reports and disclosures about its "commitment to these principles."ⁿ⁶

It bears emphasizing that, under the DII principles, the code of conduct is the foundation of each organization's compliance program, with other principles defining the means by which the code is effectively communicated and enforced.

[iii] *Substance, Training and Enforcement of the Code of Conduct*

Each DII signatory has flexibility within the principles to construct a compliance program and code of conduct that best fits its organization and business. Nonetheless, most organizations have adopted codes of conduct that combine general expressions of fundamental values and principles, such as honesty, integrity and fair-dealing, with more specific provisions to address relevant risk areas. The latter subjects may include issues that apply to the widest range of officers and employees in the company such as conflicts of interest, antitrust, employment of former government employees, gifts and entertainment, use of company resources, books and records, bidding for and pricing of government contracts, procurement integrity, confidential information, work place conduct issues such as discrimination and harassment, political contributions, privacy and insider trading.ⁿ⁷

This model of combining the general with the specific--of addressing both values and conduct--is one that can prove useful to organizations in any industry, in response to the requirements of Sarbanes-Oxley and the stock exchange listing standards. As noted by the DII in its 2008 Report,

A written code of conduct is also intended to provide clear guidance to employees as they face an ethics dilemma. Thus, codes commonly pinpoint the major ethics and conduct risks of the particular business, as well as including more general, aspirational objectives.

Thus, codes commonly pinpoint the major ethics and conduct concerns of the particular business, as well as a statement of more general corporate aspirational objectives. All the codes of DII signatories state unequivocally the expectation that employees will comply with applicable laws, regulations, and company policies. All codes contemplate that employees will "do the right thing" when there is no rule.ⁿ⁸

The DII has worked since its inception to improve the communications, training, monitoring, enforcement and reporting mechanisms that are reflected in its principles and that can help make the codes of conduct more effective. For example, DII signatories typically provide a copy of their code to all employees and require that they acknowledge receipt of the code and their obligation to comply with it. Companies may also distribute their code to subcontractors, consultants, vendors, and suppliers. The codes all emphasize the importance of asking questions, reporting concerns or seeking guidance when the legality or propriety of an action is unclear. Annual DII conferences and other meetings review new on-line and in-person training methods, monitoring and auditing techniques, discipline programs and recent regulatory concerns.

The DII Principles and guidance are more important than ever, The Defense Contract Audit Agency of the U.S. government has issued formal letter requests to major defense contractors seeking detailed information about their "control environments." The agency is requesting, among other things, information about "the existence of written codes of conduct" as well as "compliance training, communication and periodic reviews."ⁿ⁹

The DII is thus an excellent source of examples, ideas and best practices regarding codes of conduct. Indeed, the DII's goals for its principles echo the post-Enron hopes for codes of conduct and related corporate governance mandates, that they will help each organization "maintain the highest ethical standards, [by] encouraging employees to ethical conduct, and requiring compliance in the course of its business activities."ⁿ¹⁰

[b] Federal Sentencing Guidelines for Organizations

[i] *Development of the FSGO*

The DII principles contributed greatly to the development of the federal sentencing guidelines for organizations ("FSGO"), perhaps the single most influential step in the evolution of corporate codes of conduct until the Sarbanes-Oxley Act.

In the five years between the founding of the DII and adoption of the FSGO, many voices urged more widespread adoption of corporate codes of conduct. As one relevant example, the Treadway Commission, which examined fraudulent financial reporting well before the twenty-first century financial scandals, recommended that every public company have a code of conduct:

Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. As part of its ongoing oversight of the effectiveness of internal controls, a company's audit committee should review annually the program that management establishes to monitor compliance with the code.ⁿ¹¹

The FSGO subsequently gave companies a very good reason to follow that advice. These guidelines were developed as part of a congressionally-mandated reform of federal sentencing that began with the creation and appointment of the United States Sentencing Commission (the "Sentencing Commission") in 1984.ⁿ¹² The Sentencing Commission, a permanent body of three judges and four other persons appointed by the President and confirmed by the Senate, was given the responsibility to create rules that would reduce the vast sentencing discretion then given to federal judges. In 1987, the Sentencing Commission issued the first binding sentencing guidelines applicable to individual defendants. The guidelines created ranges for each sentence, based on the "offense level" for the particular crime and the offender's "criminal history" score.

The Sentencing Commission next focused on the adoption of guidelines for the sentencing of organizations convicted of federal crimes.

[ii] Purpose and Structure--The "Carrot and Stick"

After three years of study and public comment, the FSGO were adopted as Chapter Eight of the sentencing guidelines and became effective on November 1, 1991.ⁿ¹³ They contain a similar system of sentencing ranges, this time using two criteria: a "base fine" that reflects the seriousness of the offense and a "culpability score" for the offending organization. Taken together, these factors define a range of possible fines for the sentencing court to use in determining the penalty imposed on an organization in each case. In addition to being fined, organizations can be placed on probation and ordered to make restitution.

Like its efforts with the sentencing guidelines for individuals, the Sentencing Commission sought through the FSGO to reduce variations in the sentencing of organizations by limiting the discretion of federal judges. But the Sentencing Commission hoped to influence organizational behavior in far broader and more fundamental ways.ⁿ¹⁴

First, the FSGO are not limited to corporations. Instead, they apply to "any organization," which includes "corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated associations, government and political subdivisions thereof, and non-profit organizations."ⁿ¹⁵

Second, the guideline ranges for organizations generally result in much stiffer fines being imposed than was the case under the prior system. The Sentencing Commission was concerned that the "unpredictability and variation in the sanctions imposed on convicted corporations meant that there was no obvious incentive to galvanize resources to avoid such sanctions." Fines were inconsistently imposed, or "less expensive than avoiding liability in the first place."ⁿ¹⁶

Third, and most important, the Sentencing Commission expressly adopted what many commentators have called a "carrot and stick" approach to the sentencing of organizations, one that offers a tangible benefit to organizations with codes of conduct and compliance programs. The key for our purposes is that an organization's culpability score generally will be determined by (i) the steps taken by the organization prior to the offense to prevent and detect criminal conduct, (ii) the level and extent of the involvement in or tolerance of the offense by senior management or the board of directors, and (iii) the organization's actions after the offense has been committed.¹⁷

As noted by the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (the "Ad Hoc Advisory Group"), which was appointed by the Sentencing Commission in February 2002 to review and suggest changes in the FSGO: The centerpiece of the [FSGO] is the fine range, from which a sentencing court selects the precise fine to impose on a convicted organization ... Guidelines provide for substantial fines when a convicted organization has encouraged, or has been indifferent to, violations of the law by its employees, but impose significantly lower fines when a corporation has demonstrated in specified ways its antipathy toward lawbreaking.¹⁸

In fact, organizations can reduce their culpability score, and thus their possible fine, by as much as 90 percent, which can translate into savings of millions of dollars, if they have taken the steps outlined below, including the adoption of a code of conduct. This "carrot and stick" approach remains in the Guidelines today, even after recent changes in the definitions of the specific steps that organizations must take to earn this credit.

One reason that the Sentencing Commission chose this approach was to address, albeit in an indirect way, standards of organizational criminal liability that were (and remain), as one expert explains, "indifferent to the culpability of the organization--as opposed to those agents within the organization--for the criminal acts." Criminal liability can attach to an organization based on the conduct of its employees or agents, *even when that conduct is contrary to company policy*:

The imputed culpability liability theory fails to distinguish between offenses committed with the participation or encouragement of upper management, pursuant to corporate policies or procedures, and those committed by "rogue employees" whose acts violated company policy or could not have been prevented by careful supervision.¹⁹

The Sentencing Commission wanted to address this issue by distinguishing those organizations which tried to prevent the wrongdoing from those which did not, and at least giving the former meaningful credit at sentencing for their efforts.

The Sentencing Commission's goals--reflected in its "carrot and stick" approach--were even more ambitious than that. As noted in the report of the Ad Hoc Advisory Group, the Sentencing Commission wanted not only to define the punishment for convicted organizations but also to affect organizational behavior outside the courtroom. The idea was to create a sentencing system that encourages organizations to prevent crime in the first instance, and to detect and disclose offenses more often and much sooner when they do occur. The Sentencing Commission "structured its framework to create a model for the good 'corporate' citizen; use the model to make organizational sentencing fair and predicable; and ultimately employ the model to create incentives for organizations to deter crime."²⁰ It is because of these incentives that the impact of the FSGO on organizational governance and compliance activities has been so profound.

[iii] Definition of an "Effective" Compliance Program in the 1991 Guidelines

The Sentencing Commission's "carrot and stick" approach was codified in the 1991 FSGO in several related provisions. An organization's culpability score--and thus the penalty that it faced--could be substantially reduced if "the offense occurred despite an effective program to prevent and detect violations of law."²¹ The FSGO defined an "effective program" as one "that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct." To meet this standard, an organization was obligated to exercise "due

diligence in seeking to prevent and detect criminal conduct by its employees and other agents."n22

This due diligence required "at a minimum" that the organization have taken seven steps including the establishment of compliance policies and procedures such as a code of conduct; compliance background reviews of key personnel; compliance communications and training; monitoring and auditing of business unit compliance with the policies and procedures; consistent enforcement and discipline; appropriate responses to compliance problems; and assignment of compliance responsibility and oversight to "specific individual(s) within high-level personnel of the organization."n23

These seven elements of an effective compliance program represented the first time that compliance program standards were defined in federal law. Here, as with the DII Principles, the code of conduct--representing "compliance standards and procedures"--was the centerpiece of an "effective" compliance program.

In addition to the credit that an organization could get for taking these steps, it could reduce its culpability score by reporting the offense to the government, cooperating with any investigation into the matter and accepting responsibility for the crime.n24

The FSGO further provided that the structure and shape of each organization's compliance program should depend on the size of the organization, the "likelihood that certain offenses may occur" because of the nature of its business and its prior history, including any previous offenses. Indeed, "an organization's failure to incorporate and follow applicable industry practice or the standards called for by any applicable governmental regulation weighs against a finding of an effective program to prevent and detect violations of law."n25 Moreover, even organizations with compliance programs could be denied sentencing credit if "high-level personnel ... or an individual responsible for the administration or enforcement of [the] program ... participated in, condoned, or was willfully ignorant of the offense."n26

The original FSGO served as the foundation for two decades of organizational compliance efforts, and they continue to influence and be reflected in judicial criteria, regulatory expectations and compliance "best practices."

[iv] *The November 2004 Amendments to the FSGO*

The compliance program elements of the FSGO were not altered from their inception in 1991 until November 2004. As discussed above,n27 in February 2002, the Sentencing Commission appointed the Ad Hoc Advisory Group to review and evaluate the effectiveness of the guidelines, with "particular emphasis on examining the criteria for an effective program to ensure an organization's compliance with the law."n28 The Ad Hoc Advisory Group decided at the outset that the "widespread misconduct in some of the nation's largest publicly held companies ... required evaluation of whether the compliance efforts precipitated by the organizational sentencing guidelines could be made more effective in preventing and detecting violations of law."n29 It then spent eighteen months studying the evolution and impact of organizational compliance programs in the period since the adoption of the FSGO.

The conclusions of the group are reflected in its report to the Sentencing Commission on October 7, 2003. The Ad Hoc Advisory Group recommended that the Sentencing Commission create a stand-alone guideline defining an "effective" compliance program, in order to highlight the importance of these provisions.n30 The compliance program definition was, at the time, part of the "Commentary to United States Sentencing Guidelines § 8A1.2 (Application Instructions-Organizations)" in Chapter Eight of the sentencing guidelines.

The group also reiterated the basic elements of the existing FSGO, but at the same time, proposed substantive changes to the seven elements, including amendments that would mandate, rather than suggest, the steps that organizations must take to qualify for this credit. These changes were designed to create more rigorous standards for evaluating organizational compliance programs.

In another significant development, the Ad hoc Advisory Group recommended that the Guidelines spell out the

responsibilities of an organization's governing authority and organizational leadership for compliance efforts and the compliance culture.ⁿ³¹ Finally, the changes sought to extend compliance efforts beyond mere compliance with written legal standards to the development of "an organizational culture that encourages a commitment to compliance." This emphasis on culture and leadership is likewise reflected in the rules for codes of conduct that were developed in 2003 by the SEC and the stock exchanges after Sarbanes-Oxley. In each of these efforts, the code of conduct became an even more central part of an effective compliance program.

On April 30, 2004, the Sentencing Commission submitted its final proposal to Congress, otherwise largely adopting the recommendations of the Ad Hoc Advisory Group, including the recommendation to create a standalone guideline.ⁿ³² The Commission's proposed changes to the FSGO took effect on November 1, 2004, without any further modifications by Congress.ⁿ³³ This created a new standard against which organizational compliance programs are now evaluated.

The amended FSGO continue to reflect many of the same elements of an "effective" compliance program that were central to the 1991 guidelines. For example, the amended guidelines continue to require that organizations (1) "establish standards and procedures to prevent and detect criminal conduct," (2) use reasonable efforts not to employ in key positions "any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program," and (3) respond appropriately and effectively to criminal conduct.ⁿ³⁴

At the same time, the 2004 FSGO amendments make three significant changes to the original guidelines.

First, the 2004 amendments have made mandatory certain elements that were simply encouraged in the prior version. For the first time, they provide that:

- (1) Organizations must conduct "effective training programs" and otherwise disseminate information about their compliance and ethics programs.ⁿ³⁵
- (2) Organizations must include "monitoring and auditing" in their efforts to ensure that the compliance and ethics program "is followed."ⁿ³⁶
- (3) Organizations "shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify" their programs to reduce that risk. These risk assessments must be customized to reflect the specific issues and concerns faced by the organization based on its industry, size and structure, and compliance history.ⁿ³⁷
- (4) Organizations must "have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation."ⁿ³⁸
- (5) The compliance and ethics program must be "promoted and consistently enforced" through both "appropriate incentives" and "appropriate disciplinary measures."ⁿ³⁹

Second, as recommended by the Ad Hoc Advisory Group, the 2004 FSGO amendments have added specific references to the responsibilities of the board of directors and senior management:

- (1) "The organization's governing authority [its Board of Directors] shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight" of the implementation and effectiveness of the program.ⁿ⁴⁰
- (2) Senior leaders of the organization must ensure that it has an effective compliance and ethics program,

as defined by the guidelines.ⁿ⁴¹

(3) Senior leaders and the Board must also receive periodic reports about the effectiveness of the compliance and ethics program, from the individuals with operational responsibility for the program.ⁿ⁴²

(4) The individual responsible for the compliance and ethics program must be given "adequate resources, appropriate authority, and direct access" to the organization's board of directors. The Sentencing Commission also noted that "a large organization shall devote more formal operations and greater resources in meeting the requirements of this guideline than shall a small organization."ⁿ⁴³

This means that board members and senior executives must be knowledgeable about substantive compliance issues and risks, as well as about compliance program activities. According to the Conference Board, because of these standards and the recent scandals, most boards of directors will now "have greater involvement with or oversight" of their organization's compliance and ethics program.ⁿ⁴⁴

Third, and perhaps most significant, the 2004 amendments to the FSGO added an entirely new element to the definition of an "effective" compliance program. For the first time, they required organizations to "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law." This simple, straightforward, one-line emphasis on culture in addition to process has introduced a more demanding and intrusive element into the equation, one that has the potential to dramatically broaden the impact of the FSGO on organizational leadership and conduct. That this potential is already being realized is reflected in the comments and expectations of regulators, especially the Securities and Exchange Commission, which we will explore in more detail later in this Chapter.

Like the 1991 guidelines, the amended FSGO also provide that, in addition to having an effective compliance and ethics program, organizations can get credit at sentencing for "self-reporting, cooperation and acceptance of responsibility."ⁿ⁴⁵ In fact, the "Introductory Commentary" that accompanies the revised guidelines in Chapter Eight of the Guidelines Manual states that "[t]he two factors that mitigate the ultimate punishment of an organization are: (i) the existence of an effective compliance and ethics program; and (ii) self-reporting, cooperation, or acceptance of responsibility." This latter factor, as we shall see below, has become increasingly important to regulators and prosecutors.

One change in 2004 proved especially controversial and was later reversed by the Sentencing Commission, in response to complaints from the Association of Corporate Counsel, the United States Chamber of Commerce and other interested parties. Commentary to this section in 2004 explained that "[w]aiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score [under these provisions] unless such a waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization."ⁿ⁴⁶ A group of former U.S. attorneys general wrote in August 2005 that this commentary—rather than encourage a case-by-case consideration of the issue—has instead been interpreted by prosecutors as providing "[c]ongressional ratification of the Department [of Justice's] policy of routinely asking that privilege be waived."ⁿ⁴⁷ The National Association of Criminal Defense Lawyers (NACDL) called this "probably one of the most important issues, post-Enron, facing the white-collar criminal defense bar"ⁿ⁴⁸ On May 1, 2006, the Commission ruled on the controversy and submitted to Congress proposed changes in the FSGO, including a recommendation to eliminate the language regarding waiver of the attorney-client privilege and work-product protections. According to the Commission, this provision was added in 2004 with the expectation that "such waivers will be required on a limited basis. Subsequently, the Commission received public comment and heard testimony [at two public hearings] that the sentence at issue could be misinterpreted to encourage waivers."ⁿ⁴⁹ On November 1, 2006, this change became effective in the absence of action by Congress. The battle over waivers by organizations of the attorney-client privilege is still being waged on other fronts, as discussed later in this chapter.

The FSGO can be found in Appendix 13-A to this Chapter.

On January 12, 2005, the United States Supreme Court ruled that the federal sentencing guidelines must be treated as only advisory, not mandatory.ⁿ⁵⁰ This means that judges must still consider the guidelines when imposing sentences on individual or corporate defendants but are not obligated to apply them in each case. Nonetheless, an organization finding itself in front of a federal judge for sentencing should still want to be able to demonstrate its commitment to compliance, ethics and self-policing, as evidenced by its faithful and effective adherence to the principles and elements of the FSGO. More important, the use of the FSGO as the standard by which organizations are judged--and the impact of the FSGO outside the courtroom--remain as real as ever, for the reasons discussed below.

[v] *Impact of the FSGO*

The Sentencing Commission has succeeded, perhaps beyond even its own expectations, in promoting the growth of organizational compliance programs and the adoption of codes of conduct as part of these programs. Its "elements of an effective compliance program" have become--as we shall see in subsequent sections of this chapter--common elements of compliance programs regardless of the industry and irrespective of whether the organization using them has ever been investigated or prosecuted for a federal crime.

Companies have developed compliance programs based on these elements in response to industry regulations, in an effort to adopt "best practices" or simply for protection in the event of federal prosecution if one or more employees do engage in misconduct. According to the report of the Ad Hoc Advisory Group, "there is abundant evidence that the organizational sentencing guidelines have, directly and indirectly, galvanized organizations to focus on their responsibility to detect and prevent violations of law and to institute compliance programs toward this goal."ⁿ⁵¹

This influence far exceeds the direct impact of the FSGO in the federal courts. According to a report by the Conference Board, from 1993 through 2008, only three of the 2,811 sentenced organizations received any credit for having an effective compliance program.ⁿ⁵² In its 2008 Annual Report, the Sentencing Commission noted that none of the organizations sentenced that year saw its culpability score reduced for having an "effective" compliance program, although 77 organizations did get credit for self-reporting, cooperating with the authorities and/or accepting responsibility.ⁿ⁵³ However, as noted by the Ad Hoc Advisory Group: The extremely small number ... is potentially misleading because it seriously understates the value of an effective compliance program. A number of government programs offer leniency to organizations that self-report violations in a timely manner, such as the U.S. Department of Justice's Antitrust Division's Corporate Amnesty policy. Moreover, the key regulatory and enforcement agencies, including the SEC and the Department of Justice, continue to use the elements of the FSGO as *their* guide in determining how organizations should be treated. Current and former U.S. Justice Department officials have stated to the Advisory Group that the Department has declined prosecutions based on the existence of an effective compliance program. An effective compliance program enables organizations to detect violations at an earlier stage than might otherwise occur, and it may thus give them the opportunity to self-report and qualify for lenient treatment under government policies.ⁿ⁵⁴

In 2002, representatives of the U.S. Department of Justice ("DOJ") told the Ad Hoc Advisory Group that "the organizational sentencing guidelines have been a dramatic step forward in corporate criminal law and organizational management ... We strongly believe that these efforts by managers can significantly reduce the likelihood and impact of organizational crime." These high-ranking officials made clear the DOJ's view that, at least "for large publicly-traded corporations the absence of any compliance program will signal a significant deviation from recognized practice."ⁿ⁵⁵

The amendments to the FSGO, and also the entire report of the Ad Hoc Advisory Group, should be carefully reviewed by compliance officers and counsel, even in those organizations which already have compliance programs based on the original elements in the sentencing guidelines. The amended FSGO represent the current, most influential standard by which organizational compliance programs and codes of conduct will be evaluated and the actual conduct of directors and officers will be judged.

[c] *Caremark* and Related Cases

[i] *The Caremark Case*

Whereas the DII made codes of conduct a key part of a prominent industry's response to scandal and the FSGO made codes of conduct an element of our criminal justice system, it was the *Caremark* decision⁵⁶ that brought compliance and codes of conduct into the boardrooms of American corporations. In what is widely regarded as a watershed case, the influential Delaware Chancery Court considered the responsibility of corporate directors to make sure that their organizations implement programs for legal and regulatory compliance. The court also addressed the personal liability of directors for failing to do so. *Caremark*, a health-care company, had pleaded guilty to criminal fraud in 1995, in connection with allegations that it illegally paid doctors for patient referrals to *Caremark* facilities and violated other federal and state health-care laws. The company paid \$250 million in criminal fines and civil penalties.

One year later, the Delaware Chancery Court was asked to approve the settlement of a shareholder derivative suit alleging that the *Caremark* directors had breached their duty of care by failing to prevent the fraud by the company's employees. The suit sought reimbursement to the company of the fines and penalties, but the settlement did not provide such relief. The court approved the settlement, concluding that there was little likelihood that the directors in this case had "breached any duty to appropriately monitor and supervise the enterprise."⁵⁷

At the same time, the court did not let corporate directors off the hook in regards to oversight of their organization's legal and regulatory compliance:

[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the Board concludes is adequate, exists, ... [T]he failure to do so may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.⁵⁸

The goal of this system is "to provide to senior management and the Board itself timely, accurate information sufficient to allow management and the Board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." The required system of information and reporting must be on ongoing, so that it is "in concept and design adequate to assure the Board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."⁵⁹

The *Caremark* court specifically referred to the FSGO in connection with the kind of system that corporations should implement, noting that the sentencing guidelines "offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial effort ... Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that the federal sentencing guidelines offer."⁶⁰

Moreover, in approving the settlement, the court favorably reviewed the compliance procedures that the company had adopted. These included:⁶¹

- (1) Adoption and publication of a new ethics manual for employees that included a toll-free hotline for employees to confidentially report possible violations of law or company policy;
- (2) New policies to prevent misconduct in government programs; and
- (3) Establishment of an audit plan to test legal and regulatory compliance.

[ii] Cases Interpreting *Caremark*

Cases interpreting *Caremark* have admonished corporate directors that they breach their duty of care if they intentionally or recklessly disregard "'red flags' that warned of systematic fraudulent practices employed and encouraged by ... management."ⁿ⁶² In one case, the red flags included audit results, a whistleblower lawsuit, a federal investigation and a series of articles in the *New York Times* regarding a hospital company's billing practices.ⁿ⁶³ In another case, the court found a "sustained and systematic failure of the Board to exercise oversight" when the Audit Committee of the Board of Directors "took no steps in an effort to prevent or remedy" the company's repeated and well-documented noncompliance with FDA requirements.ⁿ⁶⁴ In a third case, the Delaware Chancery Court provided some examples that would constitute a failure to meet the *Caremark* standards: "That the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."ⁿ⁶⁵

In the absence of "red flags" that put them on notice of wrongdoing, directors are liable for breaching their duty of oversight under Delaware law only if (a) they "failed to implement any reporting or information systems or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations."ⁿ⁶⁶ Thus, directors may discharge their duty of oversight, in appropriate circumstances, by ensuring that a company has an adequate compliance program and periodically receiving reports from the officers responsible for the operation of the program.

In *Stone v. Ritter*, the Delaware Supreme Court affirmed the dismissal of a derivative action when it was clear from the face of the pleadings (including from a report incorporated by reference) that "the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing ... [reports required under the Bank Secrecy Act] and monitoring compliance, and exercised oversight by relying on periodic reports from them."ⁿ⁶⁷

More recently, the Delaware Chancery Court refused to second-guess the directors of Citigroup for failing to protect the organization and its shareholders from the risks of the sub-prime mortgage market.ⁿ⁶⁸ The court explained that the "[o]versight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk."ⁿ⁶⁹ The court noted that the plaintiffs had conceded that "Citigroup had a risk monitoring system in place."ⁿ⁷⁰

Especially following these cases interpreting *Caremark*, there can be no doubt that having an effective corporate compliance program and code of conduct protects directors, as well as their organizations. The board of every U.S. public company, as a whole or through one of its committees, should be sure that (a) an "adequate" compliance program, with a suitable code of conduct a centerpiece, has been implemented and is operating effectively, (b) relevant legal and regulatory risks are addressed as part of this program, and (c) any serious compliance-related problems are brought to the attention of senior management for review and response and, when they are material to the consolidated enterprise as a whole, are reported to the board of directors.

[d] The Government's View of Codes of Conduct--Compliance Guidance for Health-Care Companies

[i] *OIG Compliance Guidance--General*

Organizations in any industry searching for the government's perspective about, and expectations for, codes of conduct and compliance programs should also review the model "Compliance Program Guidance" documents issued for the various components of the health-care system by the Office of Inspector General (OIG) of the federal Department of Health and Human Services. These are the most detailed and comprehensive organizational compliance guidance prepared by regulators in any industry, and they have been relied upon by other government agencies outside of health

care, including the Department of Justice. The OIG has stated that "[t]he development of these types of compliance program guidances is based on our belief that a health care provider can use internal controls to more efficiently monitor adherence to applicable statutes, regulations and [federal] program requirements."ⁿ⁷¹

The OIG has issued compliance program guidance for at least 13 separate segments of the health-care industry. While each contains sections geared toward the specific component at issue such as managed care organizations or physician practices, these guidance documents share many common characteristics and provisions.ⁿ⁷² Moreover, although adoption of the program elements and activities in these documents is "voluntary," every organization involved in federal health-care programs must have a compliance program, and most have wisely taken the OIG's guidance and advice about the shape and substance of those programs.

Each of these guidance documents is based on the compliance program elements of the FSGO. One of the steps recommended by the OIG in every compliance program guidance document is for health-care organizations to implement "compliance and practice standards through the development of written standards and procedures." According to the OIG, "[w]ritten standards and procedures are a central component of any compliance program." Other basic components, reflecting the compliance program elements found in the DII Principles and the FSGO, include monitoring and auditing, training and education, discipline procedures, "open lines of communication," prompt disclosure of compliance violations and the designation of a compliance officer.ⁿ⁷³

The standards "should function in the same fashion as a constitution, i.e., as a fundamental document that details the fundamental principles, values and framework for action within the organization." Much like the DII principles,ⁿ⁷⁴ these regulations include the consequences for failure to comply with these rules:

The standards should not only address compliance with statutes and regulations, but should also set forth broad principles that guide employees in conducting business professionally and properly. In short, the standards should promote integrity, support objectivity and foster trust.ⁿ⁷⁵

The OIG recommends that companies also establish "a comprehensive set of written policies addressing all applicable statutes, rules, and [Medicare] program instructions." These policies should address identified risk areas and contain more specific procedures for employees to follow, than would be found in the standards of conduct.

[e] Compliance Perspectives of Other Agencies

Similar reliance on the compliance program elements of the FSGO, including the requirement for compliance-related policies and procedures such as a code of conduct, can be found in the policies of other agencies.

[i] *The Environmental Protection Agency*

In 2000, the federal Environmental Protection Agency ("EPA") issued a revised enforcement and voluntary disclosure policy that expressly provides incentives for "self-policing: discovery, disclosure, correction and prevention."ⁿ⁷⁶ This policy gives organizations the opportunity to avoid prosecution for environmental law violations if, among other things, they discover violations through "a compliance management system that reflects due diligence in preventing, detecting and correcting violations." According to the policy, this system must specifically reflect compliance program elements that are similar to those in the FSGO, including "compliance policies, standards and procedures that identify how employees and agents are to meet the requirements of laws, regulations, permits, enforceable agreements and other sources of authority for environmental requirements."

[ii] *The State Department*

As another example, the U.S. Department of State has issued compliance criteria for registered exporters and manufacturers of arms.ⁿ⁷⁷ These criteria include "corporate commitment and policy with directives by senior company

management; ... internal monitoring and audits to ensure the integrity of the compliance program; training; procedures for voluntary disclosure; confidential advice ... to employees; procedures to foster employee discipline such as keying certain types of advancement to compliance understanding and implementation; and the establishment of internal disciplinary mechanisms."

[iii] *Financial Services Regulators--Anti-Money Laundering*

The USA Patriot Act of 2001 (the "Patriot Act"), the congressional response to the attacks of September 11, 2001, requires a broad range of financial institutions to establish programs to prevent and combat money laundering.ⁿ⁷⁸ These programs must include, at a minimum:

- (1) Internal policies, procedures and controls;
- (2) Designation of a compliance officer for the program;
- (3) Ongoing employee training; and
- (4) An independent audit of the program.

Regulations to implement this section of the Patriot Act, from various agencies including the New York Stock Exchange, the Financial Industry Regulatory Authority (FINRA) and its predecessor the National Association of Securities Dealers ("NASD") and the U.S. Treasury Department, go into greater detail about what must be in the anti-money-laundering compliance programs. In every instance, the regulations reflect the FSGO's elements of an effective compliance program and, in the process, place a set of compliance policies and procedures at the center of these private-sector efforts to fight terrorism and crime.

For example, one of the first anti-money laundering regulations, Special NASD Notice to Members 02-21, provided that member financial services firms must "establish and implement policies and procedures that can be reasonably expected to detect and cause" the reporting of possible money laundering and that are "reasonably designed to achieve compliance" with federal anti-money laundering regulations:

Further, in developing program criteria, firms should consider the guidelines established by the United States Sentencing Commission in the U.S. Sentencing guidelines for organizations, as well as the fiduciary responsibilities of officers and directors to ensure that the firm's compliance programs are viable and effective.ⁿ⁷⁹

For another example, in 2007, the Federal Financial Institutions Examination Council issued the latest in a series of Comprehensive Bank Secrecy Act/Anti-Money Laundering Examination Manual.ⁿ⁸⁰ This Manual reiterates the obligations of banks to "develop, implement and maintain effective AML (anti-money laundering) programs that address the ever changing strategies of money launderers and terrorists." These programs must be tailored to each bank's specific risks and must include "policies, procedures, and processes" for ensuring compliance with all applicable regulations. Similarly, on November 3, 2005, the Financial Crimes Enforcement Network (FINCEN) issued a final rule requiring that insurance companies establish anti-money laundering compliance programs that, at a minimum, include policies, procedures and internal controls; a designated compliance officer; on-going training for "appropriate persons"; monitoring of compliance by the company's brokers and agents; and a process for updating the program "as necessary."ⁿ⁸¹

[iv] *The Securities and Exchange Commission*

WorldCom

In 2002, the SEC responded to one of the more spectacular corporate frauds of the era--WorldCom--by obtaining a permanent injunction requiring the company to secure an independent review of its "corporate governance systems, policies, plans and practices" including "whether WorldCom has an adequate and appropriate code of ethics and business conduct, and related compliance mechanisms."⁸² In addition to this requirement, the federal judge overseeing the securities fraud case against WorldCom ordered the company to train employees on business ethics and required that a sworn "Ethics Pledge" be signed by the Chief Executive Officer. The company then agreed to extend the pledge requirement to others in senior management and ultimately to all employees.⁸³

Investment Advisors

Similarly, one reaction of regulators to the mutual fund scandals that erupted in 2003 was a final rule from the SEC to require that all registered investment companies adopt a code of ethics, including comprehensive written policies and procedures designed to prevent violations of federal laws and regulations. These organizations must also appoint designate a compliance officer to implement and help enforce these policies and procedures:

We urge advisors to take great care and thought in preparing their codes of ethics, which should be more than a compliance manual. Rather, a code of ethics should also set out ideals for ethical conduct premised on fundamental principles of openness, integrity, honesty and trust. A good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct, and should challenge employees to live up not only to the letter of the law, but also to the ideals of the organization.⁸⁴

The Seaboard Report

On October 23, 2001, the SEC issued an influential document--the so-called 21(a) Report in the *Seaboard* case.⁸⁵ This report explained why the agency was taking enforcement action against the former controller of a public company's subsidiary, but *not* taking action against the public company itself. The SEC noted that "self-policing, self-reporting, remediation and cooperation with law enforcement" are "unquestionably important in promoting investors' best interests." It then detailed 13 criteria that the agency will consider in determining whether to bring charges and, if so, the *severity* of charges brought and sanctions to be sought. Among these criteria are the extent of the harm, the level of personnel involved, the immediacy and effectiveness of the company's response to the misconduct, and the timeliness and completeness of its notification to and cooperation with regulators. Moreover, regulators must ask if the company has adopted "new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct?"

The Seaboard report has become a must-read for corporate counsel and compliance officers confronted with allegations of misconduct and a road-map for how their organizations should respond to these allegations in an effort to avoid the most damaging outcomes. As former SEC Commissioner Glassman has remarked, companies in trouble should "get good counsel--counsel that understand our rules and processes ... [I]t is [also] important that you are aware of and understand the relationship of cooperation to SEC enforcement decisions--the so-called 'Seaboard' factors that we may consider in determining sanctions."⁸⁶

In a significant, related development, the SEC on January 4, 2006, issued a "Statement of the Securities and Exchange Commission Concerning Financial Penalties".⁸⁷ The statement was released to "provide the maximum possible degree of clarity, consistency, and predictability" in the Commission's exercise of its authority to punish organizations for violations of federal securities laws and regulations. Among the factors that the SEC will consider are whether the organization has taken any remedial steps and the extent of the company's cooperation with the regulators: "The degree to which a corporation has self-reported an offense, or otherwise cooperated with the investigation and remediation of the offense, is a factor that the Commission will consider in determining the propriety of a corporate penalty." In one

contemporaneous example, the SEC charged six former officers of a financial institution with fraud but not the institution itself because of the company's "swift, extensive and extraordinary cooperation." This cooperation included "prompt self-reporting, an independent internal investigation, sharing the results of that investigation with the government [without asserting applicable privileges], terminating and otherwise disciplining responsible wrongdoers, providing full restitution to its defrauded clients, and implementing new controls designed to prevent the recurrence of fraudulent conduct."ⁿ⁸⁸

This policy statement has been the subject of fierce debate regarding the appropriateness and scope of corporate versus individual penalties. In the course of this debate, SEC commissioners and staff have offered their views on the value of organizational compliance efforts. Commissioner Louis Aguilar has suggested that, in determining whether a corporate penalty is warranted, regulators should consider "[t]o what degree was the company's culture respectful of the law, on the one hand, or driven to achieve particular results on the other hand? Did the company have appropriate policies and procedures reflecting best practices for its size, business and other circumstances? Was the board vigilant in overseeing management and steering the company?" He added his confidence "that companies can design efficient systems of compliance if properly motivated."ⁿ⁸⁹

In September 2009, the SEC filed settled Regulation FD charges against a chief financial officer for his selective disclosure of material, non-public information to a group of analysts. In deciding not to bring charges against the company, the SEC explained that the organization had "cultivated an environment of compliance" by adopting relevant policies and providing training. The company also promptly reported the matter, cooperated with the investigation and added controls to prevent future problems.ⁿ⁹⁰

However the larger debate about corporate penalties turns out, it is likely that regulators will continue responding to scandals, organizational failings and industry problems by either mandating that organizations adopt and enforce codes of conduct and other appropriate controls in the relevant areas of concern or giving credit to those organizations that have done so when they decide whether to pursue penalties against the organization and, if so, how harsh those penalties should be.

[f] The Department of Justice

[i] *The Holder Memorandum*

In 1999, the Department of Justice (the "DOJ") officially added its influential voice to the encouragement and advice received by organizations regarding codes of conduct, by issuing for all federal prosecutors a document entitled *Bringing Criminal Charges Against Corporations*.ⁿ⁹¹ This document, named the "Holder Memorandum" because it was written by then Deputy Attorney General (later Attorney General) Eric Holder, provided "guidance as to what factors should generally inform a prosecutor in making the decision whether to charge a corporation in a particular case." By its terms, then, this document moved questions about acceptable compliance programs from the end of the criminal justice process--the sentencing of convicted organizations--to far more frequent, and much earlier, pre-charging deliberations by prosecutors.

The Holder Memorandum devoted an entire section to corporate compliance programs. This section began by noting that the DOJ "encourages such corporate self-policing, including voluntary disclosures to the government of any violations that a corporation discovers on its own."ⁿ⁹² The memorandum then followed with the less encouraging statement that "the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that corporate management is not adequately enforcing its program."

Nonetheless, a compliance program could make a difference, according to the Holder Memorandum, especially with

regard to whether the corporation would be criminally charged for the misdeeds of its employees:

Prosecutors should ... attempt to determine whether a corporation's compliance program is merely a "paper program" or whether it was designed and implemented in an effective manner ... In addition, prosecutors should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it. This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the organization's employees and agents.ⁿ⁹³

The memorandum explained that the DOJ did not have its own "formal guidelines for effective compliance programs," and it specifically referred prosecutors to the FSGO "[f]or a detailed review of these and other factors concerning corporate compliance programs." The memorandum further suggested that prosecutors look to the experiences of the Department of Defense, the Department of Health and Human Services, the EPA and the SEC (experiences we have discussed earlier in this chapter) for assistance in this regard.ⁿ⁹⁴

[ii] *The Thompson Memorandum*

Three and a half years after issuing the Holder Memorandum, in the midst of the Enron investigation and other corporate scandals, the DOJ revised its guidance for prosecutors who were deciding whether to charge organizations with federal crimes. On January 20, 2003, the Department issued the "Thompson Memorandum," which was authored by then Deputy Attorney General Larry D. Thompson, who was also head of the President's Corporate Fraud Task Force. This document, entitled *Principles of Federal Prosecution of Business Organizations* (hereinafter referred to as the "Principles"), reaffirmed the guidance in the Holder Memorandum, with some important changes.ⁿ⁹⁵ For example, in contrast to its predecessor, it specifically defines "corporation" to include "all types of business organizations, including partnerships, sole proprietorships, government entities, and unincorporated associations."ⁿ⁹⁶

More importantly, the Thompson Memorandum said that "in all cases involving corporate wrongdoing, prosecutors *should* consider the factors discussed herein."ⁿ⁹⁷

The compliance program section provided that federal prosecutors, in "conducting an investigation, determining whether to bring charges, and negotiating plea agreements" should consider, among a number of factors, "the existence and adequacy of the corporation's compliance program."ⁿ⁹⁸ This section largely repeated the corresponding section of the Holder Memorandum, including the references to the FSGO and related compliance guidance from various regulators. Prosecutors had to ask the same questions that corporate counsel should be asking about the organization's compliance program: "Is the compliance program well-designed?" and "Does the corporation's compliance program work?" Among the issues that prosecutors should review are whether the organization's compliance program is "designed to detect the particular types of misconduct most likely to occur" in its line of business and whether the program has been given "staff sufficient to audit, document, analyze, and utilize the results" of its compliance efforts.

Federal prosecutors were urged to determine whether the organization has established "corporate governance mechanisms" to prevent and detect misconduct:

[A]re the directors provided with information sufficient to enable the exercise of independent judgment; are internal audit functions conducted at a level sufficient to ensure their independence and accuracy and have the directors established an information and reporting system in the organization reasonably designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law.ⁿ⁹⁹

The Thompson Memorandum then cited the *Caremark* decision to support this line of inquiry. This discussion of corporate governance and the role of the board of directors undoubtedly reflected the government's view that the failure of the Enron board of directors to meet this standard contributed to the company's collapse, and that an organization cannot have an "effective" compliance program without the active involvement of its "governing authority" in establishing, overseeing and continually evaluating the program.

Another section of the Thompson Memorandum echoed the recommendation of its predecessor that a prosecutor also consider a corporation's remedial actions once misconduct has been revealed, "including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies."¹⁰⁰

One change in the Thompson Memorandum proved especially contentious. It instructed prosecutors to increase their "emphasis on and scrutiny of the authenticity of a corporation's cooperation" with the government. In deciding whether to charge an organization, prosecutors were to consider the organization's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client privilege and work product protection." The Memorandum further explained that, in assessing an organization's cooperation, prosecutors should determine if the company has retained errant employees without sanction or advanced attorneys' fees to employees under investigation. Among the difficult issues that the memorandum raised was whether the government would expect or require that an organization waive its protections to receive credit for cooperation.¹⁰¹

An unlikely coalition of corporate counsel, defense attorneys and business groups including the Business Roundtable and the U.S. Chamber of Commerce was organized to resist this perceived effort to weaken the attorney-client privilege. One outcome of the efforts of this Coalition to Preserve the Attorney-Client Privilege was the introduction in the 110th Congress by Senator Arlen Specter (R-Pa) of the "Attorney-Client Privilege Act of 2007." The Act finds that "the ability of an organization to have effective compliance programs and to conduct comprehensive internal investigations is enhanced when there is clarity and consistency regarding the attorney-client privilege." As such, the Act would generally prohibit federal prosecutors from demanding waiver of the privilege from an organization under investigation or from conditioning "a civil or criminal charging decision" on "any valid assertion of the attorney-client privilege or privilege for attorney work product." On February 13, 2009, the Act was reintroduced by Senator Specter.

In the meantime, the application of the Thompson Memorandum was successfully challenged in a prosecution involving KPMG, in which the district court issued three successive opinions.¹⁰² In the first opinion, the court found that pressure from prosecutors, based on the Thompson Memorandum, caused KPMG to refuse to advance attorneys' fees for its current and former employees, reversing longstanding company policy. Such pressure, the court held, violated the individual defendants' *Fifth* and *Sixth Amendment* rights. In the second ruling, the court suppressed statements made by two of the defendants following threats by KPMG to fire them if they did not cooperate with the government. In the court's view, "the government is responsible for the pressure that KPMG put on its employees. It threatened KPMG with the corporate equivalent of capital punishment. KPMG took the only course open to it."¹⁰³ [Citation.]

In the third ruling, dismissing the charges against 13 of the individual defendants, the court concluded that the prosecution's application of the Thompson memorandum violated due process because none of the defendants had "the resources to defend this case as he or she would have" had the prosecutors not "prevented" KPMG from continuing to pay their defense costs. The government's "deliberate interference with the defendants' rights was outrageous and shocking in the constitutional sense because it was fundamentally at odds with two basic constitutional values—the right to counsel and the right to fair criminal proceedings."¹⁰⁴

These events led the Justice Department to issue yet another memorandum on this subject.

[iii] *The McNulty Memorandum*

On December 12, 2006, then Deputy Attorney General Paul McNulty issued a memorandum superseding the Thompson Memorandum.ⁿ¹⁰⁵ While the McNulty Memorandum carried over many of the principles of the Holder Memorandum and the Thompson Memorandum, it departed from the prior guidance in two significant ways. The changes largely reflected pressure from defense lawyers, bar associations and others--as well as litigation, court decisions and the proposed legislation--in response to the Department of Justice's policies and practices in the areas of (a) waivers of the attorney-client privilege and (b) corporations' advancement of legal fees to subjects and targets of investigations.

The McNulty Memorandum required that federal prosecutors seek written approval within the Department of Justice before requesting waivers of the attorney-client privilege or work-product protection. It also stated the Department's policy regarding the attorney-client privilege and the work product doctrine. In remarks accompanying release of his memorandum, Deputy Attorney General McNulty asserted that "attorney-client communications should only be sought in rare cases." The Memorandum then detailed the test that prosecutors must meet in order to demonstrate these uncommon circumstances. Even with regard to "relatively non-controversial" requests to companies for *factual* information, the McNulty Memorandum required that prosecutors now establish a need for the information in written requests for approval to their United States Attorney, who must consult with officials of DOJ's Criminal Division. Further, the McNulty Memorandum generally prohibited prosecutors, in assessing companies' cooperation with the government, from considering whether they are advancing attorneys' fees to their employees or agents. In return for these concessions, Deputy Attorney McNulty challenged corporate counsel to "insist on compliance with the law ... to stand up against those in corporate leadership who pillage corporate coffers to benefit themselves rather than their shareholders."ⁿ¹⁰⁶

Contrary to the Justice Department's hope, the McNulty memorandum did not end the debate or the pressure to modify its approach to corporate cooperation and privilege. So the Justice Department produced yet another memorandum, one that seems to have quieted many of the critics.

[iv] *The Filip Letter and Memorandum*

On July 28, 2008, then Deputy Attorney General Mark Filip sent a letter to Senators Patrick Leahy and Arlen Specter informing them that he had completed an internal review of the Justice Department's Principles of Federal Prosecution of Business Organizations. He did so in response to the continuing claim that the Department was forcing corporations to waive their attorney-client and work product privileges in order to get credit under these principles for cooperating with the government. He also was responding to concerns, reflected in the KPMG case, that the Department was improperly limiting or refusing to grant cooperation credit when "the corporation has advanced attorneys' fees to its employees, failed to fire or sanction allegedly culpable employees, or entered into joint defense agreements."

In August 2008, following a series of meetings the Department held with in-house counsel, criminal-defense attorneys and other interested parties, the Justice Department completed revisions to the Principles to address these issues. These revisions provide that:

- Cooperation by organizations will be determined based on the facts that are disclosed to the prosecution, not by the waiver of privileges.
- Prosecutors will not insist on the disclosure of "core attorney-client privileged communications" or "non-factual" work product before granting cooperation credit.
- Prosecutors will not consider either the advancement of attorneys' fees or joint defense agreements in evaluating cooperation.
- In evaluating the organization's compliance program but not in assessing its cooperation, the

government will consider whether and how a company disciplines its employees.

Most important for purposes of this chapter, this new version of the Principles maintains the emphasis on whether the corporation being sentenced has an effective compliance program, reiterating the language from the Holder Memorandum that a corporation's adoption of "a truly effective compliance program ... may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation." This emphasis in the revised Principles substantiates one of the underlying principles of this chapter: A compliance program can prevent violations of law or regulations or, in the case of violations by individual employees, can help insulate a company from prosecution or an enforcement action.

The Filip Letter and Memorandum with the revised Principles of Federal Prosecution of Business Organizations can be found in Appendix 13-B to this chapter.

[g] The United States Supreme Court

Beginning in 1998, the United States Supreme Court decided a series of cases that further enhanced the value of organizational compliance programs and codes of conduct. These cases all arose in the context of employment discrimination litigation.

In two of these cases, the Court gave employers an affirmative defense to their liability for sexual harassment by supervisory employees, at least in those cases in which a "hostile work environment" rather than a tangible employment action such as discharge or demotion is at issue:

The defense comprises two necessary elements: (a) that the employer exercised reasonable care to prevent and correct promptly any sexually harassing behavior, and (b) that the plaintiff employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to avoid harm otherwise.¹⁰⁷

Among the steps that could constitute "reasonable care" by an employer are the adoption and effective communication of a policy against sexual harassment, as well as the availability to all employees of "a sensible complaint procedure" that enables them to raise issues and instances of concern to the management of the organization.¹⁰⁸

The following year, the Court held that an employer can avoid liability for punitive damages in connection with "the discriminatory management decisions of managerial agents" if it can show that "those decisions are contrary to the employer's good faith efforts" to comply with anti-discrimination laws. The Court in this case made reference to the policies and "grievance mechanisms" discussed in the two earlier cases, concluding that the purposes of anti-discrimination laws are "advanced where employers are encouraged to adopt anti-discrimination policies and to educate their personnel."¹⁰⁹

A number of lower court cases interpreting and applying these opinions by the Supreme Court have stressed the importance of developing and implementing an anti-discrimination policy; repeatedly communicating this policy to all employees; training employees about its provisions; providing a means for employees to report instances of possible discrimination; promptly and thoroughly investigating those reports; and taking appropriate action to enforce the policy, including discipline of offenders.¹¹⁰ As one court explained, there is "a form of safe haven for employers who promulgate and support an active anti-harassment policy."¹¹¹

In one such case involving a claim of sexual harassment, the New Jersey Supreme Court held that employer's anti-harassment policy must be more than just a "paper policy"; it must reflect an "unequivocal commitment from the top that [the organization's policy against sexual harassment] is not just words but is backed up by consistent practice."¹¹² The court emphasized the policy should also be part of a comprehensive program including formal

policies prohibiting harassment, training for supervisors and managers, "complaint structures" for employees to use, and a demonstrated commitment to monitoring and consistent enforcement.¹¹³

These steps mirror the FSGO's elements of an effective compliance program, and as a result, many organizations have incorporated their anti-discrimination policy into an overall compliance program. These organizations have included the substantive and procedural program elements listed in these cases in their company-wide codes of conduct.

[h] The Business Community Responds

[i] *The Business Roundtable & The Conference Board*

The business community responded to the corporate accounting scandals that began with the collapse of Enron in 2001 by encouraging self-policing and correction. In May 2002, the Business Roundtable issued an influential report, *Principles of Corporate Governance*.¹¹⁴ It concluded that:

A corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and efficiently.¹¹⁵

This report recommended that senior management, particularly the CEO, set a "tone at the top" that establishes an organizational "culture" of compliance and integrity and also that the audit committee of the board of directors--if not the full board--review the corporation's procedures addressing legal and regulatory compliance, including the code of conduct. The Business Roundtable updated these Principles in November 2005, reinforcing the importance of a comprehensive code of conduct and reminding management of its responsibility "to take reasonable steps to develop, implement and maintain an effective legal compliance program."¹¹⁶

Another influential business organization, The Conference Board, called for companies to make their boards of directors "responsible for overseeing corporate ethics ... including adherence to the law's requirements." Specific "best practices suggestions" included a list of items that matched the FSGO's elements of an effective compliance program:

- (1) Programs to ensure that employees understand, apply, and adhere to the company's code of ethics;
- (2) Designation of an officer to oversee ethics and compliance with the code of conduct;
- (3) Processes that encourage and make it safe for employees to raise ethical issues and report possible ethical violations;
- (4) Processes for prompt investigation of complaints and prompt disposition, including discipline and corrective action, if necessary; and
- (5) Processes to measure and track employees' adherence to the company's ethical requirements and to assess the ethical performance of the company.¹¹⁷

These organizations recognized that it was better to implement a compliance program proactively, based on the FSGO and including a code of conduct, than to do so during or after an investigation.

[ii] *Sarbanes-Oxley Act Emergers*

This is where matters stood in the spring of 2002, as Congress considered the Sarbanes-Oxley Act--its response to the scandals in corporate governance and accounting. There was a large body of experience with corporate codes of conduct, and growing acceptance by public officials and private industry of the merits of including such codes in any

comprehensive measures to address organizational misconduct. The Sarbanes-Oxley Act became the first of three steps that--over a two-year period--brought all of this experience to bear in a highly significant way.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewCriminal Law & ProcedureSentencingGuidelinesGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. *U.S. v. Twentieth Century Fox Film Corp.*, 882 F.2d 656, 660 (2d. Cir. 1989) .

(n2)Footnote 2. See SEC Release Nos. 38-8177, 34-47235, "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" (March 27, 2003), *available at* <http://www.sec.gov/rules/final/33-8177.htm>.

(n3)Footnote 3. See An Interim Report to the President by the President's Blue Ribbon Commission on Defense Management (1986), at 21.

(n4)Footnote 4. The Defense Industry Initiative on Business Ethics and Conduct: 2006 Annual Report to the Public, at 6 [hereinafter DII 2006 Annual Report], *available at* www.dii.org.

(n5)Footnote 5. See Public Accountability Report of the Defense Industry Initiative for Business Ethics and Conduct, January 1, 2008 to June 30, 2009, *available at* www.dii.org.

(n6)Footnote 6. The Defense Industry Initiative on Business Ethics and Conduct, Article III, DII Principles, *available at* www.dii.org/Statement.htm.

(n7)Footnote 7. DII 2006 Annual Report at 19-31.

(n8)Footnote 8. DII 2006 Annual Report at 19.

(n9)Footnote 9. See "Internal Control Matrix for Control Environment and Overall Accounting Controls," Version 5.0, *available at* www.dcaa.mil.

(n10)Footnote 10. The Defense Industry Initiative on Business Ethics and Conduct, Article III, DII Principles, *available at* www.dii.org/Statement.htm.

(n11)Footnote 11. See Report of the National Commission on Fraudulent Financial Reporting (1987), at 35, *available at* www.coso.org.

(n12)Footnote 12. The Sentencing Reform Act of 1984, Pub. L. No. 98-473, 98 Stat. 1987.

(n13)Footnote 13. U.S. Sentencing Guidelines Manual, Ch.8 (Nov. 2002) [hereinafter "1991 USSG" or the "1991 Guidelines Manual"].

(n14)Footnote 14. See Nagel, I. & Swenson, W. M., *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 Wash. U.L.Q. 205, 214-217 (1993).

(n15)Footnote 15. 1991 USSG § 8A1.1, Application Note 1.

(n16)Footnote 16. *See* Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (Oct. 7, 2003) [hereinafter Ad Hoc Advisory Group Report], at 12.

(n17)Footnote 17. 1991 USSG, Ch. 8, Introductory Commentary.

(n18)Footnote 18. Ad Hoc Advisory Group Report at 20. For further discussion of the Ad Hoc Advisory Group, *see* § 13.02[2][b][iv] below.

(n19)Footnote 19. Jennifer Moore, *Corporate Liability Under the Federal Sentencing Guidelines*, 34 *Ariz. L. Rev.* 743.759 (1992).

(n20)Footnote 20. Ad Hoc Advisory Group Report at 14.

(n21)Footnote 21. 1991 USSG, § 8C2.5(f) ("Effective program to Prevent and Detect Violations of Law").

(n22)Footnote 22. 1991 USSG, § 8A1.2, Application Note 3(k).

(n23)Footnote 23. 1991 USSG § 8A1.2, Application Note 3(k).

(n24)Footnote 24. 1991 USSG, § 8C2.5(g) ("Self-Reporting, Cooperation, and Acceptance of Responsibility").

(n25)Footnote 25. 1991 USSG, § 8A1.2 Application Note 3(k).

(n26)Footnote 26. 1991 USSG, § 8C2.5(f).

(n27)Footnote 27. *See* § 13.02[2][b][ii] above.

(n28)Footnote 28. *See* News Release, The Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group (Feb. 21, 2002), *available at* www.ussc.gov/PRESS/rel0202.htm. This action by the Sentencing Commission would later help it to meet the mandate in Sarbanes-Oxley Act Section 805(a)(2)(5) that it determine if the FSGO are "sufficient to deter and punish organizational criminal misconduct."

(n29)Footnote 29. Ad Hoc Advisory Group Report at 3.

(n30)Footnote 30. Ad Hoc Advisory Group Report at 4.

(n31)Footnote 31. Ad Hoc Advisory Group Report at 4-5.

(n32)Footnote 32. *See* Amendments to the Sentencing Guidelines, Policy Statements, and Official Commentary (May 1, 2004), *available at* www.ussc.gov/2004guid/2004cong.pdf.

(n33)Footnote 33. The amended FSGO (as set forth in the 2004 Federal Sentencing Guidelines Manual, Chapter 8 "Sentencing of Organizations") are reproduced in Appendix 13-A to this chapter, "Federal Sentencing Guidelines for Organizations (As amended, effective Nov. 1, 2004)." Hereinafter, citations to sections of the amended FSGO are to "USSG § 8.2.1."

(n34)Footnote 34. USSG §§ 8B2.1(b)(1), (3) and (7).

(n35)Footnote 35. USSG § 8B2.1(b)(4)(A).

(n36)Footnote 36. USSG § 8B2.1(b)(5)(A).

(n37)Footnote 37. USSG § 8B2.1(c).

- (n38)Footnote 38. USSG § 8B2.1(b)(5)(C).
- (n39)Footnote 39. USSG § 8B2.1(b)(6).
- (n40)Footnote 40. USSG § 8B2.1(b)(2)(A).
- (n41)Footnote 41. USSG § 8B2.1(b)(2)(B).
- (n42)Footnote 42. USSG § 8B2.1(b)(2)(C).
- (n43)Footnote 43. *See* USSG § 8B2.1 Application Note 2(C)(ii).
- (n44)Footnote 44. Ronald M. Berenbeim and Jeffrey Kaplan, Ethics Programs: The Role of the Board--A Global Study, Research Report 1344, at 7 (The Conference Board 2004).
- (n45)Footnote 45. USSC § 8C2.5(g).
- (n46)Footnote 46. USSC § 8C2.5 Application Note 12.
- (n47)Footnote 47. *See* Waiving privilege a crucial sentencing issue, National Law Journal, Aug. 29, 2005, at 6.
- (n48)Footnote 48. *See* Waiving privilege a crucial sentencing issue, National Law Journal, Aug. 29, 2005, at 6.
- (n49)Footnote 49. www.usc.gov; *see also* 71 FR 28063-28073 .
- (n50)Footnote 50. *United States v. Booker*, 543 U.S. 220 (2005) .
- (n51)Footnote 51. Ad Hoc Advisory Group Report at 29.
- (n52)Footnote 52. Ethics and Compliance Enforcement Decisions: the Information Gap, The Conference Board, June 2009, *available at* www.conference-board.org.
- (n53)Footnote 53. U.S. Sentencing Commission, Annual Report 2006, at pages 41-42, *available at* www.usc.gov.
- (n54)Footnote 54. Ad Hoc Advisory Group Report at 26-27.
- (n55)Footnote 55. *See* Testimony of the United States Department of Justice Before the Ad Hoc Advisory Group (Nov. 14, 2002) at 19.
- (n56)Footnote 56. *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) .
- (n57)Footnote 57. *Caremark*, 698 A.2d at 961.
- (n58)Footnote 58. *Caremark*, 698 A.2d at 970.
- (n59)Footnote 59. *Caremark*, 698 A.2d at 970.
- (n60)Footnote 60. *Caremark*, 698 A.2d at 968-70.
- (n61)Footnote 61. *Caremark*, 698 A.2d at 963-66.
- (n62)Footnote 62. *McCall v. Scott*, 239 F. 3d 808, 819 (6th Cir. 2001) .
- (n63)Footnote 63. *See McCall*, 239 F.3d at 819 .

(n64)Footnote 64. *In re Abbott Labs. Derivative Litig.*, 325 F.3d 795, 809 (7th Cir. 2003) .

(n65)Footnote 65. *Guttman v. Huang*, 823 A.2d 492, 507 (Del. Ch. 2003) ; *see also American Int'l Group v. Greenberg*, 965 A.2d 763, 801 (D. Ch. 2009) (denying, in part, motions to dismiss claims against certain director defendants when allegations of the complaint supported an inference that they were aware of "pervasive, earnings-related frauds").

(n66)Footnote 66. *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006) ; *see also In re SFBC Intern. Inc.*, 495 F. Supp. 2d 477, 484-85 (D.N.J. 2007) ("lack of good faith can be established by a sustained or systematic failure of the board to exercise oversight").

(n67)Footnote 67. *Id.*, *Stone v. Ritter*, 911 A.2d 362, 373 (Del. 2006) ; *see also Midwestern Teamsters Pension Trust Fund v. Deaton*, Civ. Action No. H-08-1808 2009 U.S. Dist. LEXIS 50521 (S.D. TX, May 27, 2009) (directors were not responsible for violations of the Foreign Corrupt Practices Act, even when committed by a company already under a cease-and-desist order for similar violations, because the board and the company had taken steps as part of its compliance program to comply with a prior order and prevent violations).

(n68)Footnote 68. *In re Citigroup Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009) .

(n69)Footnote 69. *Id.*, *In re Citigroup Shareholder Derivative Litigation*, 964 A.2d 106, 131 (Del. Ch. 2009) (emphasis in original).

(n70)Footnote 70. *Id.*, *In re Citigroup Shareholder Derivative Litigation*, 964 A.2d 106, 129 (Del. Ch. 2009) .

(n71)Footnote 71. *See, e.g.*, Publication of the OIG's Compliance Program Guidance for Medicare+Choice Organizations offering Coordinated Care Plans [hereinafter "OIG Compliance Program Guidance"], 64 Fed. Reg. 61893 (Nov. 15, 1999) .

(n72)Footnote 72. These and other compliance program documents are *available at* www.oig.hhs.gov/fraud/complianceguidance.html.

(n73)Footnote 73. OIG Compliance Program Guidance, 64 Fed. Reg. at 61896.

(n74)Footnote 74. *See* § 13.02[2][a][ii] *above*.

(n75)Footnote 75. OIG Compliance Program Guidance, 64 Fed. Reg. at 61893-61896.

(n76)Footnote 76. *See* Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention, 65 Fed. Reg. 19618 (Apr. 11, 2000) .

(n77)Footnote 77. *See* Guidelines for DTC Registered Exporter/Manufacturers Compliance Program, *available at* www.pmdtc.org/docs/Compliance_Programs.pdf.

(n78)Footnote 78. Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat 322, § 352(a).

(n79)Footnote 79. Special NASD Notice to Members 02-21 (Apr. 2002), *available at* www.finra.org; *see also* FINRA Rule 3310--Anti-Money Laundering Compliance Programs.

(n80)Footnote 80. FFIEC, Bank Secrecy Act/Anti-Money Laundering Examination Manual, *available at* http://www.ffiec.gov/bsa%5Faml%5Ffinfobase/documents/BSA_AML_Man_2007.pdf.

(n81)Footnote 81. *See* 70 FR 66761 .

(n82)Footnote 82. SEC Litigation Release No. 17866 (Nov. 26, 2002); Accounting and Auditing Enforcement Release No. 1678 (Nov. 26, 2002).

(n83)Footnote 83. See *Securities and Exchange Commission v. WorldCom, Inc.*, 273 F. Supp. 2d 431, 433 (S.D.N.Y. 2003). This requirement was reflected in the Corporate Monitor's final report, which also included the following recommendation: "The Company should commit to the highest standards of excellence in its ethics programs generally, and to the operation of a strong and effective Ethics Office within the management structure. The leadership of the Ethics Office should be someone with a very substantial level of legal experience, ideally including direct regulatory or law enforcement experience. The board should review all ethics programs thoroughly not less than annually, and should receive regular updates on the nature of issues that may arise." See Restoring Trust, Recommendation 10.04, at p.142, available at http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf (Aug. 2003).

(n84)Footnote 84. See SEC Final Rule: Investment Advisor Codes of Ethics [Release no. IA-2256, IC-26492; File No. S7-04-04] (July 2, 2004), at 4.

(n85)Footnote 85. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Release No. 34-44969 (Oct. 23, 2001) available at <http://www.sec.gov/litigation/investreport/34-44969.htm>.

(n86)Footnote 86. Speech by SEC Commissioner Cynthia Glassman, Remarks before the European Corporate Governance Summit: An SEC Commissioner's View: The Post-Sarbanes-Oxley Environment for Foreign Issuers, at 6 (Mar. 2, 2005) available at <http://www.sec.gov/news/speech/spch030205cag.htm>.

(n87)Footnote 87. Available at www.sec.gov.

(n88)Footnote 88. SEC Litigation Release No. 19517, January 3, 2006.

(n89)Footnote 89. Speech by Commissioner Luis A. Aguilar, "Reinvigorating the Enforcement Program to Restore Investor Confidence," March 18, 2009, available at <http://www.sec.gov/news/speech/2009/spch031809laa.htm>.

(n90)Footnote 90. See SEC v. Christopher A. Black, Case No. 09-CV-0128, SEC Litigation Release No. 21222 (Sept. 24, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21222.htm>.

(n91)Footnote 91. See Office of the Deputy Attorney General, Bringing Criminal Charges Against Corporations (attaching the document "Federal Prosecution of Business Organizations") (June 16, 1999) [hereinafter Holder Memorandum], available at www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html.

(n92)Footnote 92. Holder Memorandum at § VII(A).

(n93)Footnote 93. Holder Memorandum at § VII(B).

(n94)Footnote 94. Holder Memorandum at § VII(B).

(n95)Footnote 95. Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (attaching revisions to the Holder Memorandum) (Jan. 20, 2003) [hereinafter Thompson Memorandum], available at www.usdoj.gov/dag/cftf/corporate_guidelines.htm and reproduced in Appendix 13-B to this chapter.

(n96)Footnote 96. Thompson Memorandum.

(n97)Footnote 97. Thompson Memorandum at section I (Charging a Corporation). This requirement gave added significance to the more controversial sections of the memorandum that are discussed below.

(n98)Footnote 98. Thompson Memorandum at § VII (Charging a Corporation: Corporate Compliance Programs).

(n99)Footnote 99. Thompson Memorandum at § VII (Charging a Corporation: Corporate Compliance Programs).

(n100)Footnote 100. Thompson Memorandum at § VIII (Charging a Corporation: Restitution and Remediation).

(n101)Footnote 101. Thompson Memorandum at § VI (Charging a Corporation: Cooperation and Voluntary Disclosure).

(n102)Footnote 102. *See U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) ; *U.S. v. Stein*, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) ; *U.S. v. Stein*, 495 F. Supp. 2d 390 (S.D.N.Y. 2007) . *See also Stein v. KPMG, LLP*, 486 F.3d 753 (2d. Cir. 2007) .

(n103)Footnote 103. *U.S. v. Stein*, 440 F. Supp. 2d 315, 319 (S.D.N.Y. 2006) .

(n104)Footnote 104. *U.S. v. Stein*, 495 F. Supp. 2d 390, 414 (S.D.N.Y. 2007) .

(n105)Footnote 105. P. McNulty, Principles of Federal Prosecution of Business Organizations, *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf.

(n106)Footnote 106. The Coalition to Preserve the Attorney Client Privilege continues to lobby for greater protection for the attorney-client privilege and attorney work product in the face of government investigations and prosecutions - does not believe that the McNulty Memorandum goes far enough in these areas. These leaders are concerned that the Memorandum will not significantly change what they view as the "culture of waiver" within the Justice Department. They also note that companies will still face pressure to waive privileges because organizations can get credit from the government for doing so.

(n107)Footnote 107. *Faragher v. City of Boca Raton*, 524 U.S. 775, 807 (1998) ; *Burlington Indus., Inc. v. Ellerth*, 524 U.S. 742, 765 (1998) . *See also Pa. State Police v. Suders*, 542 U.S. 129 (2004) .

(n108)Footnote 108. *Faragher*, 524 U.S. at 808 .

(n109)Footnote 109. *Kolstad v. American Dental Ass'n*, 527 U.S. 526, 545 (1999) .

(n110)Footnote 110. *Compare, e.g., E.E.O.C. v. Wal-Mart Stores, Inc.*, 187 F.3d 1241 (10th Cir. 1999) and *Deffenbaugh-Williams v. Wal-Mart Stores, Inc.*, 188 F.3d 278 (5th Cir. 1999) with *Hatley v. Hilton Hotels Corp.*, 308 F.3d 473 (5th Cir. 2002) .

(n111)Footnote 111. *Cavuoti v. N.J. Transit Corp.*, 161 N.J 107, 121 (1999) .

(n112)Footnote 112. *Gaines v. Bellino*, 801 A.2d 322, 332 (N.J. 2002) (quoting *Lehmann v. Toys 'R' Us*, 132 N.J. 587, 621 (N.J. 1993)).

(n113)Footnote 113. *Gaines*, 801 A.2d at 329 .

(n114)Footnote 114. The Business Roundtable is "an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.5 trillion in revenues."

(n115)Footnote 115. Business Roundtable, Principles of Corporate Governance at 9-10 (May 2002), *available at* www.businessroundtable.org/pdf/704.pdf.

(n116)Footnote 116. Business Roundtable, Principles of Corporate Governance at 34 (November 2005), reproduced as Appendix A to this treatise.

(n117)Footnote 117. The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 2: Corporate Governance, Principle VI: Ethics Oversight at 32 (2003), *available at* www.conference-board.org/pdf_free/758.pdf.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.03

AUTHOR: Jay M. Cohen

§ 13.03 Section 406 of the Sarbanes-Oxley Act of 2002

[1] Objectives for Sarbanes-Oxley Section 406

Congress demonstrated more than just acceptance of organizational codes of conduct in the Sarbanes-Oxley Act of 2002ⁿ¹ (the "Sarbanes-Oxley Act" or "Sarbanes-Oxley"); in Section 406, it made these codes a necessary part of the governance of every public company.ⁿ² Section 406 occupied little more than one page of the 130-page Act, but its construction has ensured a much bigger impact. In fact, this section set off a round of rule-making by the SEC and the stock exchanges that--at each step along the way--dramatically broadened both the subjects that must be included in an organizational code of conduct and the number of people covered by it.

By its title, Code of Ethics for Senior Financial Officers, Section 406 was clearly aimed at the perceived self-dealing and conflicts of interests involving the Enron chief financial officer and other high-ranking financial officials at that company. Congress acted contemporaneously with influential professional organizations like the Financial Executives International, which recommended--in light of Enron--that "all senior financial professionals be required to adhere to a strong ethical code of conduct."ⁿ³

The report of the Senate Committee on Banking, Housing and Urban Affairs, which accompanied the adoption of the Sarbanes-Oxley Act, explained Congress' reason for including Section 406 in the Act:

The problems surrounding Enron Corp. and other public companies raise concerns about the ethical standards of corporations and their senior financial managers. The Committee believes that investors have a legitimate interest in knowing whether a public company holds its financial officers to certain ethical standards in their financial dealings.ⁿ⁴

[2] Elements of the Section 406 Code

[a] "Comply or Explain"

Sarbanes-Oxley Section 406 can be divided into five elements. First, the section did not mandate that every public company have a code of ethics. Instead, it adopted a "comply or explain" approach, commanding the SEC to "issue

rules to require each issuer ... to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers."⁵ Organizations could legally choose not to have such a code as long as they justified their decision. Of course, what organization would decide to publicly explain why it did not believe such an effort at organizational integrity was necessary or appropriate, especially given the enormous public skepticism about corporate ethics and integrity at the time the Sarbanes-Oxley Act was passed?

[b] Senior Financial Officers

Second, Section 406 listed the senior financial officers required to be covered by this code as "the principal financial officer and comptroller or principal accounting officer, or persons performing similar functions."⁶ This meant that only a small number of officers and employees in each organization were implicated by this mandate although, as noted below, the SEC and the stock exchanges would choose to include a substantially wider group.

[c] Definition of "Code of Ethics"

Third, Section 406 defined the term "code of ethics" as:

Such standards as are reasonably necessary to promote--

- (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
- (3) compliance with applicable governmental rules and regulations.⁷

Understandably, in light of the scandals at the time, this section specifically referenced conflicts of interest and the accuracy and integrity of publicly-issued financial reports. Then Senator John Corzine, who proposed inclusion of the code of ethics in the Sarbanes-Oxley Act, noted that "there have been 1,100 corporate earnings reinstatements in the last 4 years. There is a basic loss of more than just the simple sense of trust that people get from the headlines. It is hard for people to make investment decisions when they don't have good facts, good numbers, and the ability to draw good conclusions about where the investor dollar should go."⁸

What is striking is that Congress also mentioned regulatory compliance and more general "honest and ethical conduct" in this section. The standards in Section 406 thus go well beyond conflicts of interest and financial reporting to potentially encompass a much broader range of organizational issues. The far reach in practice of this seemingly simple section of the Sarbanes-Oxley Act would be demonstrated in the compliance rule-making that followed.

[d] Disclosure of Changes or Waivers

Fourth, Congress ordered the SEC to mandate "the immediate disclosure, by means of filing such form [8-K], dissemination by the Internet, or by other electronic means ... of any change in or waiver of the code of ethics."⁹ Again, this was a direct response to revelations that the Enron Board of Directors may have waived the conflicts of interest provisions in that company's code of conduct, when the board approved some of the financial arrangements that led to the company's downfall. This further reflected Congress' view that requiring public disclosure of these activities would be as effective in promoting corporate integrity as prohibiting them.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. The Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

(n2)Footnote 2. Sarbanes-Oxley Act § 406, *15 U.S.C. § 7264*. Sarbanes-Oxley Act § 406 is reproduced in Appendix H to this treatise.

(n3)Footnote 3. *See* letter from Philip B. Livingston, President and CEO of Financial Executive International (Apr. 4, 2002) to the Corporate Accountability and Listing Standards Committee ("CALs") of the New York Stock Exchange, p. A-67 of the CALS Report, *available at* www.nyse.com.

(n4)Footnote 4. *See* Report of the Committee on Banking, Housing, and Urban Affairs, United States Senate, S. Rep. No. 107-205, at 32 (July 3, 2003).

(n5)Footnote 5. Sarbanes-Oxley Act § 406(a), *15 U.S.C. § 7264(a)*.

(n6)Footnote 6. Sarbanes-Oxley Act § 406(a), *15 U.S.C. § 7264(a)*.

(n7)Footnote 7. Sarbanes-Oxley Act § 406(c), *15 U.S.C. § 7264(c)*.

(n8)Footnote 8. Senate Conference Report on the Sarbanes-Oxley Act, Congressional Record p. S7356 (July 25, 2002).

(n9)Footnote 9. Sarbanes-Oxley Act § 406(b), *15 U.S.C. § 7264(b)*.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.04

AUTHOR: Jay M. Cohen

§ 13.04 SEC Rules to Implement Section 406 of the Sarbanes-Oxley Act

[1] "Comply or Explain" Remains

On January 23, 2003, the SEC issued final rules to implement Section 406, in addition to rules related to other sections of the Sarbanes-Oxley Act.ⁿ¹ This was the second step in the evolution of the code of conduct mandate. Like the Act itself, the SEC did not insist that companies have codes of ethics:

The final rules require a company to disclose whether it has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the company has not adopted such a code of ethics, it must explain why it has not done so.ⁿ²

However, "comply or explain" did not last much longer. The stock exchange listing standards that were approved after the release of these rules eliminated the "explain" option.ⁿ³

In other areas, the SEC took full advantage of the authority it was given by Congress to make a number of significant changes to the code of ethics defined by Sarbanes-Oxley.

[2] The "Principal Executive Officer" Also

The SEC determined that this code of ethics should apply to "a company's principal executive officer" in addition to the senior financial officers who had to be covered under the Sarbanes-Oxley Act. In proposing this change, the SEC said that "[i]nvestors not only have an interest in knowing whether a public company holds its senior financial officers to certain ethical standards, but also whether a public company holds its principal executive officer to ethical standards as well." At the same time, the SEC rejected suggestions to apply this requirement to other individuals in the organization such as directors, all executive officers, and employees generally, but it did "encourage companies to apply the code of ethics to as broad a spectrum of personnel and affiliates as possible."ⁿ⁴

[3] Substantive Changes

The final SEC rule defined the term "code of ethics" much more broadly than Section 406. It was now defined as "written standards that are reasonably designed to deter wrongdoing and to promote:

- (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (2) Full, fair, accurate, timely and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
- (3) Compliance with applicable governmental laws, rules and regulations;
- (4) The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- (5) Accountability for adherence to the code."⁵

[4] Process Also Matters

In the most drastic changes from the statute, the SEC added two new sections (numbers (4) and (5) in § 13.04[3] above) which require organizations to provide mechanisms for "prompt internal reporting" of any code violations and the identification of a person or persons to receive such reports,⁶ and some means to promote "accountability" for compliance with the code provisions.⁷ They were needed, according to the SEC, because "an effective code of ethics should describe the company's system for the internal reporting of code violations. The code should state clearly the consequences for non-adherence to code provisions."⁸

As the result of these substantive and procedural enhancements, the "code of ethics" mandate now incorporated a number of the elements of an "effective" compliance program, as detailed in the FSGO and the other expert guidance discussed above. The mandate's inclusion of "honest and ethical conduct" in addition to legal and regulatory compliance parallels the FSGO's new focus on an organizational culture that promotes "ethical conduct and legal compliance." It thereby has brought into play much of the private-sector experiences and public-sector expectations that we reviewed earlier in this chapter.

With regard to the individual or individuals who must be designated to help administer the code, the SEC said that "although the company would retain discretion to determine the identity of the appropriate person or persons ... we believe the person identified in the code should have sufficient status within the company to engender respect for the code and the authority to deal with persons subject to the code regardless of their stature in the company."⁹ This corresponds to the "high-level" personnel envisioned by the FSGO and adds weight to the view that compliance and ethics officers must have clout, resources and access to top management in order to be effective and acceptable to the regulators.

[5] One Code or Two?

The SEC recognized that "[m]any companies already maintain codes of ethics or conduct" and that "a pre-existing code may satisfy the requirements" of this rule. However, "if a company has a code but it does not satisfy parts of the definition [in the rule,] the company would not be able to affirm that it has the type of code contemplated by the rules." Companies may have "separate codes of ethics for different types of officers" or they may include the SEC-prescribed code as part of "a broader document that addresses additional topics or that applies to more persons" than those specified in the rule.¹⁰ The SEC, in essence, told organizations that they should choose to do the latter,

We strongly encourage companies to adopt codes that are broader and more comprehensive than

necessary to meet the new disclosure requirements.¹¹

[6] Disclosure of the Code

With respect to disclosure of the code, the SEC again went further than Section 406 in commanding that each company disclose the entire code (if it has one), as well as any waivers and amendments of it. A company can:

- (1) File the code as an exhibit to its annual report, as part of the Form 10-K;
- (2) Post the ethics report and code of conduct on the company website normally used for investor relations, as long as the company disclosed in its annual report both its intention to do so and the website address; and
- (3) Indicate in the annual report that it will provide a copy of the code to any person, without charge, upon request.¹²

Organizations which have more extensive codes, or codes that apply to a larger group of employees, need disclose only "the portions of a broader document that constitutes a code of ethics" as defined by this rule.¹³

[7] Changes or Waivers

In accordance with Section 406, the SEC rules require that companies file a Form 8-K to disclose any amendments to or changes in this code of ethics, other than technical, administrative or "non-substantive" amendments. Companies must "briefly describe the date and nature of any amendment" and then also file the amendment with its annual report. The Form 8-K must be filed within five business days of the occurrence of the event. As an alternative to filing a Form 8-K, companies can make such disclosures on their website but only with prior notice in their most recent annual report that they will be using this method of disclosure.¹⁴

Companies must similarly disclose any grant of a "waiver" including an "implicit waiver" of the provisions and application of the code. This description must include "the nature of the waiver, the name of the person to whom the waiver was granted, and the date of the waiver."

The rules define waiver as the approval by the company of a "material departure" from a provision of the code of ethics and define "implicit waiver" as the company's failure to take action "within a reasonable period of time" regarding a material departure from the code that has been made known to one of the company's executive officers.¹⁵ This places an added burden on the organization's systems for identifying, analyzing and responding to potential code violations, and for evaluating such information for possible disclosure. Interestingly, while the rules require that companies disclose waivers, they do not require that companies disclose violations.

The SEC added that:

Only amendments or waivers relating to the specified elements of the [SEC's] code of ethics and the specified officers must be disclosed. This clarification is intended to allow and encourage companies to retain broad-based business codes. For example, if a company has a code of ethics that applies to its directors, as well as to its principal executive officer and senior financial officers, an amendment to a provision affecting directors would not require Form 8-K or Internet disclosure.¹⁶

Not surprisingly, waivers of company codes of conduct have been relatively rare. Those waivers that have been disclosed range from the significant--permitting fairly substantial business dealings with outside organizations associated with company executives--to the mundane--such as permitting executives to accept gifts that exceed value

limits in the code or allowing employees who travel on company business to accept, for personal use, gifts from incentive programs offered by airlines, hotels, and car rental companies. One insurance company disclosed that it was paying a bank to provide it with commercial banking services while also owning nearly 10 percent of that bank's common stock. Another company disclosed the waiver of its code of ethics to allow it to acquire commercial real estate interests that were owned by the company's Chairman and CEO and two other directors.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. SEC Release Nos. 33-8177; 34-47235 (Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002) (Jan. 23, 2003) [hereinafter Final Rule] adding *17 CFR § 229.406* (Regulation S-K Item 406) Code of Ethics and *17 CFR § 228.406* (Regulation S-B Item 406) Code of Ethics [for Small Business Issuers]. The SEC adopted the code of ethics rule for registered investment companies in a separate release. *See* SEC Release No. 34-47262; IC-25914 (Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002) (Jan. 27, 2003). *17 CFR § 229.406* (Regulation S-K Item 406) is reproduced in Appendix H to this treatise.

(n2)Footnote 2. Final Rule at 1.

(n3)Footnote 3. *See* § 13.06[2][b] and § 13.06[3][a] below.

(n4)Footnote 4. *See* SEC Release Nos. 33-8138; 34-46701; IC-25775 (Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002) (Oct. 16, 2002) [hereinafter Proposed Rule] at 19, 145 n. 65.

(n5)Footnote 5. *17 CFR § 229.406(b)*.

(n6)Footnote 6. *17 CFR § 229.406(b)(4)*.

(n7)Footnote 7. *17 CFR § 229.406(b)(5)*.

(n8)Footnote 8. Proposed Rule at 21.

(n9)Footnote 9. Proposed Rule at 146, n. 67.

(n10)Footnote 10. *See* Final Rule at 20; Proposed Rule at 22.

(n11)Footnote 11. Final Rule at 19.

(n12)Footnote 12. *17 CFR § 229.406(c)*.

(n13)Footnote 13. *17 CFR § 229.406*, Instructions to Item 406.

(n14)Footnote 14. Final Rule at 21.

(n15)Footnote 15. *See* Final Rule at 43-44; Form 8-K, Item 5.05 "Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics" and Instructions for Item 5.05 (reproduced in Appendix H to this treatise).

(n16)Footnote 16. Final Rule at 21.



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Corporate Governance: Law and Practice

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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.05

AUTHOR: Jay M. Cohen

§ 13.05 Related Sections of the Sarbanes-Oxley Act

[1] Whistleblowers

Several sections of the Sarbanes-Oxley Act were included to help encourage and protect corporate whistleblowers. These sections are relevant to our discussion about codes of conduct because organizations may choose to use their codes to explain, implement and enforce these provisions. The sections in question were included in the Sarbanes-Oxley Act in reaction to reports that Enron employees brought the company's accounting and other problems to the attention of senior management, including the chief executive officer, but got little response. It was reported that, in at least one instance, the company investigated whether it could take some employment action against an employee who raised such concerns. According to the Report of the Senate Judiciary Committee:

These examples further expose a culture, supported by law, that discourages employees from reporting fraudulent behavior not only to the proper authorities, such as the FBI and SEC, but also internally. This "corporate code of silence" not only hampers investigations, but also creates a climate where ongoing wrongdoing can occur with virtual impunity. The consequences of this corporate code of silence for investors in public-traded companies, in particular, and for the stock market in general, are serious and adverse, and they must be remedied.ⁿ¹

One important objective for the organization's code of conduct, and for the compliance officer and other internal resources helping to administer the code, is to help prevent this "code of silence" from developing.

Section 301 of the Sarbanes-Oxley Act requires that public company audit committees establish procedures for "the receipt, retention and treatment" of complaints or other concerns--from any source--about auditing and accounting matters, and for the "confidential, anonymous submission by employees" of concerns about these issues.ⁿ² Organizations may use their codes of conduct for publicizing to both employees and external audiences the availability of special telephone lines and other communications vehicles for this purpose.

Another section of the Sarbanes-Oxley Act, Section 1107, makes it a federal crime to take harmful employment action against any employee because the employee has provided law enforcement officers with "any truthful information relating to the commission or possible commission of any Federal offense."ⁿ³

A third section of Sarbanes-Oxley, Section 806, creates a civil cause-of-action for employees of public companies who believe they have suffered retaliation for providing information to the authorities, or otherwise assisting in the investigation of securities violations and other federal frauds. This section is enforced by the United States Department of Labor or by civil lawsuits in the federal courts.ⁿ⁴ The Department of Labor has assigned its responsibility to the Occupational Safety and Health Administration ("OSHA"), which administers several other whistleblower statutes for the federal government.

Three important points must be made about the scope of Section 806. First, the employee's allegations need not be correct to trigger the whistle-blower protection. The law prohibits retaliation against an employee who reports misconduct that the employee "reasonably believes" is a violation of law, even if it turns out that those violations never occurred. In 2009, the United States Court of Appeals for the Ninth Circuit ruled that two former in-house lawyers could sue for wrongful termination under section 806 of Sarbanes-Oxley without proving the truth of their claims that company officials engaged in misconduct.ⁿ⁵ In fact, OSHA does not even determine if there has been corporate wrongdoing; it only decides if the employee has been mistreated.

Second, contrary to what might be expected in a section of the Sarbanes-Oxley Act, the reported legal violations covered by this section are not limited to those involving accounting fraud and financial reporting by public companies. Under the Act, whistleblowers are protected for complaints involving possible violations of securities, bank, mail or wire fraud laws, as well as "any rule or regulation of the Securities and Exchange Commission, or any provision of federal law relating to fraud against shareholders."ⁿ⁶ In one case, Judge Sterling Johnson in the Eastern District of New York concluded that a corporate official who assisted a colleague in "opening a channel of communication with the company's CEO" in order for the colleague to complain about compensation and accounting practices had himself engaged in protected activity, even though he had "no knowledge of the company's accounting practices" other than what he was told by the colleague.ⁿ⁷ In another example, an administrative law judge held that the full protections of this section of the Sarbanes-Oxley Act applied to a vice president of the non-public subsidiary of a public company. The judge also rejected the argument that the protections did not apply because the allegedly "manipulated" financial reports were never publicly disclosed and were immaterial to the public parent company, concluding that "Sarbanes-Oxley is largely a prophylactic, not a punitive measure."ⁿ⁸ By contrast, the Department of Labor's Administrative Review Board concluded that, when a Sarbanes-Oxley whistleblower complaint relies on alleged violations of the federal mail and wire fraud statutes, "the alleged fraudulent conduct must at least be of the type that would be adverse to investors' interests."ⁿ⁹

Third, the consequences to organizations that lose whistleblower cases can be quite significant. OSHA or the courts can order reinstatement, back-pay and other awards such as attorney's fees and litigation costs.ⁿ¹⁰ To these formal consequences must be added the additional reputational damage that will follow, in the current environment, to companies deemed unfriendly to employee whistleblowers. At the same time, while the potential consequences from a whistleblower action are great, the likelihood that they will come to pass is small. According to the Department of Labor, nearly 1,300 whistleblower complaints have been filed since the passage of the Sarbanes-Oxley Act. The Department has dismissed 841 of these cases as without merit. As of the date of this writing, only 17 cases have resulted in a ruling in favor of the complainant. Of course, even with these favorable odds, no company welcomes a whistleblower claim. Companies that are now spending much time and resources on other sections of the Sarbanes-Oxley Act, such as Sections 302 and 404, would do well to make sure that they are also paying attention to Section 806.

Here again, organizations should use their codes of conduct to reinforce prohibitions against such retaliation and to inform employees of internal procedures for addressing their concerns, so that employees will not feel the need to access outside resources. As the United States Supreme Court made clear in March 2005 in a related context, when the Court concluded that the private right of action under Title IX of the Education Act encompassed claims of retaliation, "[w]ithout protection from retaliation, individuals who witness discrimination would likely not report it, indifference

claims would be short-circuited, and the underlying discrimination would go unremedied."¹¹ The Court reemphasized the importance of employee protection against retaliation in a 2009 case, in which it concluded that the law protected an employee who did not initiate a complaint but who reported evidence of sexual harassment in response to questions during an internal investigation.¹²

This reasoning applies with equal force to the full-range of organizational misconduct.

[2] Internal Controls and Codes of Conduct

Section 404 of the Sarbanes-Oxley Act requires the CEO and CFO of a public company to certify that they have established "an adequate internal control structure and procedures for financial reporting" in their organization; assessed the effectiveness of the design and operation of those controls; and had an independent evaluation by the company's outside auditor of this assessment.¹³ It is important to recognize that internal controls in this context potentially includes those non-financial business processes and procedures that can significantly impact the quality and accuracy of the information that goes into financial reports, and not just those controls specifically related to the preparation of these reports.

The SEC's final rule to implement this section requires that management identify "the framework used to evaluate the effectiveness of the organization's internal controls over financial reporting."¹⁴ The SEC further suggested that companies consider using for this purpose the control framework published in 1992 by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission. This framework requires internal controls to help organizations address the "effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations."¹⁵ Obviously, companies will take seriously any suggestion from the SEC about the process they should use to comply with this mandate.

On March 9, 2004, the Public Company Accounting Oversight Board ("PCAOB")--the government agency established by the Sarbanes-Oxley Act to oversee the accounting industry--issued standards for auditing firms to use in evaluating management's actions under Section 404. These standards also reference the COSO framework.¹⁶ As part of its evaluation of internal controls at a public company, the external auditor must review the "code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board." Auditors must also test and evaluate "company-level controls" including the "tone at the top."¹⁷ The PCAOB issued additional guidance in this regard on May 16, 2005, reiterating that "the auditor begins by identifying, understanding, and evaluating the design of company-level controls." These include "the controls within the control environment, such as the tone at the top" and "all five COSO internal control components."¹⁸

One accounting firm has concluded that "a company's failure to have a documented code of conduct approved by the board of directors and its audit committee that is operating effectively is, at a minimum, a significant deficiency and a strong indicator of a material weakness" in internal controls.¹⁹ This means that a comprehensive and effective code of conduct is necessary to help organizations address a number of their obligations under the Sarbanes-Oxley Act, in addition to Section 406.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. S. Rep. No. 107-146, at 5 (May 6, 2002).

(n2)Footnote 2. Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1(m)(4).

(n3)Footnote 3. Sarbanes-Oxley Act § 1107, 18 U.S.C. § 1513(e).

(n4)Footnote 4. Sarbanes-Oxley Act § 806, 18 U.S.C. § 1514A.

(n5)Footnote 5. *Van Arsdale v. International Game Technology*, 577 F.3d 989, 1001 (9th Cir. 2009) ("It is not critical ... that they prove that [company] officials actually engaged in fraud. Rather, the [plaintiffs] only need show that they reasonably believed that there might have been fraud and were fired for even suggesting further inquiry.").

(n6)Footnote 6. Sarbanes-Oxley Act § 806(a), 18 U.S.C. § 1514(a)(i).

(n7)Footnote 7. *Mahoney v. Keyspan Corporation*, No. CV 04-554, 2007 (E.D.N.Y. March 12, 2007).

(n8)Footnote 8. *In re Morefield v. Exelon Servs., Inc.* No. 2004-SOX-00002, 2004 WL 5030303, at *6 (U.S. Dept. of Labor, Jan. 28, 2004). *See also Fraser v. Fiduciary Trust Com.* 417 F. Supp. 2d 310, 2006 U.S. Dist. LEXIS 6467 (S.D.N.Y. Fed. 15, 2006). *Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365 (N.D. Ga., Sept. 2, 2004); *Richards v. Lexmark Int'l, Inc.*, 2004-SOX-00049 (ALJ Oct. 1, 2004); *Welch v. Cardinal Bankshares Corp.*, 2003-SOX-15 (ALJ Jan, 28, 2004).

(n9)Footnote 9. *Platone v. FLYI*, DOL ARB No. 04-154, ALJ No. 2003-SOX-27, 2006 WL 3246910, at *7 (U. S. Dept. of Labor ARB, Sept. 29, 2006), *aff'd*, *Platone v. U.S. Dept. of Labor*, 548 F.3d 322, 327 (4th Cir. 2008) ("a billing discrepancy, without more, does not equal fraud, and Platone failed to identify ... why she believed the actions related to the discrepancies would violate securities laws and constitute a fraud"). *See also, Klopenstein v. PCC Flow Technologies Holdings Inc.*, DOL ARB 04-149 (May 31, 2006) (the discharged vice-president of the *private* subsidiary of a publicly-held company can proceed with his whistleblower claim); *Richards v. Lexmark International Inc.*, DOL ALJ 2004-SOX-00049, 2006 WL3246874 (June 20, 2006) (whistleblower claim dismissed because the complainant did not establish his belief that the inventory accounting problems in question represented fraud or a violation of any SEC rules).

(n10)Footnote 10. *See Bechtel v. Competitive Tech.*, 369 F. Supp. 2d 233 (D. Conn. 2005) .

(n11)Footnote 11. *Jackson v. Birmingham Bd. of Educ.*, 544 U.S. 167 (2005) .

(n12)Footnote 12. *See Crawford v. Metropolitan Gov. of Nashville*, 129 S. Ct. 846 (2009) (without protection from retaliation, "prudent employees would have a good reason to keep quiet about Title VII offenses against themselves or others").

(n13)Footnote 13. Sarbanes-Oxley § 404, 15 U.S.C. § 7262.

(n14)Footnote 14. *See* SEC Release Nos. 33-8238; 34-47986; IC-26068 (Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports) (June 5, 2003).

(n15)Footnote 15. *See* SEC Release Nos. 33-8238; 34-47986; IC-26068 (Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports) (June 5, 2003).

(n16)Footnote 16. PCAOB Release 2004-001 (Auditing Standard No. 2- An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements) (Mar. 9, 2004). This standard

has been approved by the SEC. *See* SEC Release No. 34-49884, File No. PCAOB 2004-03 (June 17, 2004).

(n17)Footnote 17. PCAOB Release 2004-001 (Auditing Standard No. 2- An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements) (Mar. 9, 2004).

(n18)Footnote 18. PCAOB Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (Questions 38-55), May 16, 2005, *available at* http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2005/05-16.pdf. *See also* discussion of COSO internal control components in a footnote in § 14.02[2][d] *below*.

(n19)Footnote 19. *See* Key Elements of Anti-fraud Programs and Controls, A White Paper, PricewaterhouseCoopers (Nov. 2003) at 5, *available at* www.pwc.com.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.06

AUTHOR: Jay M. Cohen

§ 13.06 The Stock Exchange Code of Conduct Listing Standards

[1] SEC Approves Stock Exchange Code of Conduct Requirements

The passage of the Sarbanes-Oxley Act was the first of three key steps in making the code of conduct a required part of the governance and management of every public company. The second step was the SEC's rulemaking related to Section 406 of Sarbanes-Oxley. The third step came on November 4, 2003, when the SEC approved proposals by the New York Stock Exchange ("NYSE") and the NASDAQ Stock Market, Inc. ("NASDAQ") to require codes of conduct for all companies listed on these exchanges.ⁿ¹ The SEC worked throughout 2003 to "harmonize" the separate NYSE and NASDAQ proposals to the extent possible and to assure that the proposals from both exchanges conformed to all of its regulations adopted pursuant to the Sarbanes-Oxley Act.ⁿ²

The SEC, in finally approving these rules, noted that "requiring listed issuers to adopt a code of conduct should help foster the ethical behavior of directors, officers and employees" because they "will know the standards expected of them ... and will be made fully cognizant that their actions will be monitored."ⁿ³

The result of this rulemaking process was the adoption of similar, but not identical, codes of conduct standards for each stock exchange. In general, the NYSE standards provide more detailed and specific guidance about the substantive elements of the code.

[2] The NYSE Code of Conduct Requirements

[a] NYSE Code of Business Conduct and Ethics

Section 303A.10 of the NYSE listing standards is entitled Code of Business Conduct and Ethics. The standard itself is simple and straightforward:

Listed companies must adopt and disclose a code of business conduct for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.ⁿ⁴

The NYSE standards continue the trend of expanding the reach and substance of the code of conduct requirement. First,

companies must *adopt* and disclose their code, eliminating the option in both Sarbanes-Oxley Section 406 and the SEC rules for organizations to choose to explain why they did not need to have a code. Second, the code will now apply to all *directors, officers and employees*. Thus, a code of ethics mandate that began, in the Sarbanes-Oxley Act, by applying only to "senior financial officers" will now apply to every director, officer and employee in the organization.

Third, the NYSE standards were accompanied by a lengthy commentary, providing guidance to listed companies about the substance and operation of their codes. The NYSE made clear in the first paragraph of this commentary its goals for these codes:

No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report ethical conduct, and help to foster a culture of honesty and accountability.⁵

[b] Content of a NYSE-Listed Company's Code

The commentary to the standards gives NYSE-listed companies concrete guidance about the subjects to cover in their codes of business conduct and ethics. "Each company may determine its own policies, but all listed companies should address the most important topics, including the following":⁶

- Conflicts of interest--the commentary provides examples of conflicts and declares that the company "should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company."
- Corporate opportunities--employees, officers and directors should be prohibited from using corporate assets for personal gain, competing against the company or taking personal advantage of "opportunities" discovered through the use of company information or other assets.
- Confidentiality--employees, officers and directors should "maintain the confidentiality of information entrusted to them by the company or its customers."
- Fair dealing--everyone should "endeavor to deal fairly with the company's customer, suppliers, competitors and employees. None should take advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice."
- Protection and proper use of company assets--"all company assets should be used for legitimate business purposes."
- Compliance with laws, rules and regulations (including insider trading laws)--"Insider trading is both unethical and illegal, and should be dealt with decisively."
- Encouraging the reporting of any illegal or unethical behavior.

[c] Reporting Without Retaliation

The commentary to the NYSE standards advises companies, in no uncertain terms, that they must ensure their employees can raise issues and report concerns without fear of adverse consequences as a result. First, companies should "encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation." Second, employees should be told that they have an obligation to "report

violations of laws, rules, regulations or the code of business conduct to appropriate personnel." Third, "to encourage" such reports, companies must inform employees that they "will not allow retaliation for reports made in good faith."ⁿ⁷

[d] CEO Certification

The NYSE has mandated that each listed company CEO annually certify that "he or she is not aware of any violation by the company of NYSE corporate listing standards."ⁿ⁸ This certification, which will "focus the CEO and senior management on the company's compliance with the listing standards," must be disclosed in the company's annual report or in the annual Form 10-K filed with the SEC.ⁿ⁹

The CEO must also "promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material violation" of the corporate governance listing standards, including this section.ⁿ¹⁰ This places a premium on the organization's systems for identifying and evaluating potential violations, and then notifying senior management about them.

[e] Waiver and Disclosure

The NYSE code of conduct standards, like Sarbanes-Oxley Section 406 and the related SEC rules, also address the issues of waiver and disclosure.

With regard to waiver, the code of business conduct and ethics must require that "any waiver of the code for executive officers and directors may be made only by the board or a board committee and must be promptly disclosed to shareholders."ⁿ¹¹ The expectation is that subjecting such waivers to public scrutiny will make them extremely rare and thus prevent the kind of questionable dealings, conflicts of interest and failure to consistently apply the provisions of the code of conduct that contributed to the collapse of Enron:

This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.ⁿ¹²

As for disclosure of the code itself, each listed company must post the code on its website. The company must also include information about this disclosure in its annual proxy statement or, if the company does not file an annual proxy statement, in its annual report on Form 10-K and also provide a printed copy of the code to any shareholder who requests it.ⁿ¹³

[f] Compliance Standards and Procedures

Each code of business conduct and ethics "must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code."ⁿ¹⁴ Adoption of a comprehensive program based on the compliance standards and procedures that we have previously reviewed, such as the compliance program elements of the FSGO, will enable organizations to address these requirements.ⁿ¹⁵

[g] Enforcement

The NYSE can issue a public letter of reprimand to a company that has violated these, or any other listing, standards. "For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties."ⁿ¹⁶

[3] NASDAQ Code of Conduct Requirements

[a] NASDAQ Code of Conduct Standard

The NASDAQ adopted its own code of conduct requirement for its listed companies.ⁿ¹⁷ Each NASDAQ-listed company is required to adopt and to make publicly available a code of conduct applicable to all directors, officers, and employees. The code must comply with the definition of a "code of ethics" set out in Section 406(c) of the Sarbanes-Oxley Act and the regulations thereunder. In addition, it must provide for "an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations."ⁿ¹⁸

[b] Content of a NASDAQ-Listed Company's Code

For NASDAQ-listed companies, the code must include "such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure and compliance with laws, rules and regulations."ⁿ¹⁹ The commentary notes that "investors are harmed when the real or perceived private interest of a director, officer or employee is in conflict with the interests of the Company, as when the individual receives improper personal benefits as a result of his or her position with the Company, or when the individual has other duties, responsibilities or obligations that run counter to his or her duty to the Company" and that "there can be no questions about the duty to make ... [disclosures to regulators and investors] fairly, accurately and timely."ⁿ²⁰

[c] Company Waivers a NASDAQ-Listed Company's Code

Each NASDAQ-listed company's code must required that any waivers of the code for executive officers or directors must be approved by the board of directors or a board committee and each such waiver must disclosed in a Form 8-K within four business days or, in the case of a foreign private issuer, either in a Form 6-K or its next Annual Report on Form 20-F or 40-F.ⁿ²¹

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawSelf-Regulating EntitiesNational Association of Securities DealersSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* SEC Release No. 34-48745 (File Nos. SR-NYSE-2002-33, SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138, SR-NASD-2002-139, and SR-NASD-2002-141, NASD and NYSE Rulemaking: Relating to Corporate Governance (Nov. 4, 2003)), *68 Fed. Reg. 64154 (Nov. 12, 2003)* [hereinafter SEC Final Code Release].

(n2)Footnote 2. *See* SEC Release No. 34-47672 (Notice of Filing of Proposed Rule change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance (Apr. 11, 2003)), proposed NYSE Listed Company Manual §§ 303A, Items 6-7; SEC Release No. 34-47516 (Notice of Filing of Proposed Rule change and Amendment Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committee (Mar. 17, 2003)). *See also* SEC Final Code Release at 1-3. It should be noted that the SEC also approved a similar "code of conduct and ethics" requirement for companies listed on the American Stock Exchange. *See* Order Granting Approval of Proposed Rule Change by the American Stock Exchange LLC and Notice of Filing and Order Granting Accelerated Approval of Amendment No 2 Relating to Enhanced Corporate Governance Requirements Applicable to Listed Companies, Rel. No. 34-48863 (Dec. 1, 2003); *68 Fed. Reg. 68,432 (Dec. 8, 2003)* .

(n3)Footnote 3. SEC Final Code Release at 39, 44-45.

(n4)Footnote 4. NYSE Listed Company Manual § 303A.10. The entire NYSE Listed Company Manual § 303A, Corporate Governance Standards, is reproduced in Appendix B to this treatise.

(n5)Footnote 5. NYSE Listed Company Manual § 303A.10 Commentary.

(n6)Footnote 6. NYSE Listed Company Manual § 303A.10 Commentary.

(n7)Footnote 7. NYSE Listed Company Manual § 303A.10 Commentary.

(n8)Footnote 8. NYSE Listed Company Manual § 303A.12(a).

(n9)Footnote 9. NYSE Listed Company Manual § 303A.12(a) Commentary.

(n10)Footnote 10. NYSE Listed Company Manual § 303A.12(b).

(n11)Footnote 11. NYSE Listed Company Manual § 303A.10 Commentary.

(n12)Footnote 12. NYSE Listed Company Manual § 303A.10 Commentary. In a list of frequently asked questions about the new corporate governance listing standards, posted on the NYSE website, the exchange suggests that "[t]he distribution of a press release within 2-3 days of a board's determination to approve any waiver from the company's code of business conduct is an example of prompt notification. A company may also chose to provide website disclosure of any waiver, or provide notice to the SEC on Form 8-K." *See* NYSE Listed Company Manual Section 303A, Corporate Governance Listing Standards, Frequently Asked Questions, Section G (Feb. 13, 2004), *available at* www.nyse.com.

(n13)Footnote 13. NYSE Listed Company Manual § 303A.10 Commentary.

(n14)Footnote 14. NYSE Listed Company Manual § 303A.10 Commentary.

(n15)Footnote 15. *See* § 13.02[2][b] above.

(n16)Footnote 16. NYSE Listed Company Manual § 303A.13 Commentary.

(n17)Footnote 17. NASDAQ Listing Rule 5610, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/bookmark.asp?id=nasdaq-rule_5610&manual=/nasdaq/main/nasdaq-equityrules.

(n18)Footnote 18. NASDAQ Listing Rule 5IM-5610, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/bookmark.asp?id=nasdaq-rule_5610&manual=/nasdaq/main/nasdaq-equityrules.

(n19)Footnote 19. NASDAQ Listing Rule IM-5610, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/bookmark.asp?id=nasdaq-rule_5610&manual=/nasdaq/main/nasdaq-equityrules.

(n20)Footnote 20. NASDAQ Listing Rule IM-5610, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/bookmark.asp?id=nasdaq-rule_5610&manual=/nasdaq/main/nasdaq-equityrules.

(n21)Footnote 21. NASDAQ Listing Rule IM-5610, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/bookmark.asp?id=nasdaq-rule_5610&manual=/nasdaq/main/nasdaq-equityrules.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.07

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§ 13.07 Private Companies and Not-for-Profit Organizations

While many of these standards mandatorily apply only to public-companies, the code of conduct and corporate governance requirements adopted after Sarbanes-Oxley have become standards of "best practices" for private companies and not-for-profit organizations, as well. A 2005 PricewaterhouseCoopers survey of chief executive officers of fast-growing private companies found that a majority of these companies were improving internal controls, updating their corporate governance procedures and revising their codes of conduct.ⁿ¹ Almost 80 percent of the private companies that participated in a survey conducted by the law firm of Foley & Lardner have adopted one or more of the Sarbanes-Oxley reforms.ⁿ² In another survey, 78 percent of organizations not subject to Sarbanes-Oxley said they had a hotline or other anonymous reporting system for employees to ask questions or report concerns.ⁿ³ These organizers want to impress customers, vendors, employees, investors, potential buyers, insurance companies, banks and other lenders, and to gain the operational and financial advantages from having a strong control environment.

Non-profit organizations feel similar compulsion to address compliance issues. As one example, the University of California required every one of its 230,000 employees--from the President of the system on down--to complete an on-line training course about its ethics policy. Even the members of the Board of Regents, including California Governor Arnold Schwarzenegger, had to complete the training. The ethics policy covered such issues as compliance with university policies and encouraging employees to report misconduct. The system's President explained that "every decision we make and action we take needs to be grounded in these core values and standards."ⁿ⁴ In addition, a number of states have enacted--or are considering--new laws that mandate stronger corporate governance and compliance rules for private companies, especially not-for-profits. Any private company that is concerned about its reputation in the marketplace will be well-served by creating, implementing and enforcing the kind of comprehensive code of conduct detailed in this chapter.

In 2009, the Internal Revenue Service revised its Form 990, a public disclosure document that must be completed and filed by most non-profits including public charities, chambers of commerce, social clubs and labor unions. The IRS added a series of governance questions and disclosures to this form, because it "is convinced that good corporate governance is necessary to ensure that the organization lives up to its responsibilities as a tax-exempt organization."ⁿ⁵ Form 990 asks whether the organization has adopted policies and procedures to address such issues as conflicts of interest, record retention and destruction, and compensation. The form also asks if the organization has a written policy

to encourage and protect whistleblowers, even though there is no legal requirement for tax-exempt organizations to have such a policy. The organization must disclose how it makes these policies available to the public.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. *See* PricewaterhouseCoopers: Private Companies Applying SOX Principles as Best Practice, *reported at* www.accounting.smartpros.com (June 27, 2005).

(n2)Footnote 2. *See* What They Do in Private, Corporate Counsel September 2005 at page 24.

(n3)Footnote 3. 2006 Compliance Program and risk Assessment Benchmarking Survey, Conducted by Corpedia, Inc. and The Conference Board, *available at* www.corpedia.com.

(n4)Footnote 4. *See*, "University of California, All 230,000 UC employees required to take ethics course," San Francisco Chronicle/SFGate, January 14, 2007.

(N5)Footnote 5. Runquist, L. & Malamut, M., "The IRS's New Regulation of Nonprofit Governance," *Business Law Today* (July/August 2009) at 29.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.08

AUTHOR: Jay M. Cohen

§ 13.08 Enforcement and Compliance After Sarbanes-Oxley

[1] Government Investigations

Settlements of government investigations since the passage of the Sarbanes-Oxley Act reinforce the importance of organizational compliance programs, including codes of conduct. These settlements continue to provide a window into the government's thinking about what it takes to be a good corporate citizen. Indeed, some factors are constant, regardless of the industry or regulatory issues involved, as demonstrated by the following examples.

In July 2004, the DOJ and the SEC reached a settlement with ABB Ltd., related to violations of the Foreign Corrupt Practices Act ("FCPA"). As part of this process, the DOJ issued an opinion letter,ⁿ¹ in which the Department favorably reviewed the company's proposed FCPA compliance plan. This plan included a "rigorous anti-corruption compliance code" supported by communications, training, a "helpline," disciplinary procedures and assignment of responsibility for overseeing compliance with the code to "one or more independent [company] officials."

In March 2005, the Office of Federal Housing Enterprise Oversight ("OFHEO") reached a settlement with the Board of Directors of Fannie Mae requiring that Fannie Mae establish "an Office of Compliance and Ethics to review internal complaints, whistleblower reports and other ethics matters." The Board of Fannie Mae was also required to "cause to be conducted a review and appropriate revision of bylaws and codes of conduct to assure that they support legal and regulatory compliance."ⁿ²

On May 23, 2006, Fannie Mae signed a Consent Order requiring its Board to create an annual compliance plan; provide annual training programs on "corporate culture and expectations"; establish a Compliance Committee "to monitor and coordinate legal and regulatory compliance"; and maintain an independent Compliance, Ethics, and Investigation function. Fannie Mae also agreed to pay \$400 million to settle the matter.ⁿ³

In April 2005, Coca-Cola settled an SEC enforcement action-without any fine or other sanctions-by agreeing to maintain remedial efforts it had initiated during the course of the investigation, including the establishment of "an Ethics & Compliance Office to administer its Code of Business Conduct and ensure, among other things, that [it] conducts its business in compliance with the Code of Business Conduct and with various laws."ⁿ⁴

Likewise, when Aon settled investigations by five state agencies in three states related to contingent commissions and other business practices of the insurance broker, the company agreed to implement "company-wide written standards of conduct" related to the practices in question and to provide "appropriate training of relevant employees, including but not limited to training in business ethics, professional obligations, conflicts of interest, antitrust and trade practices compliance and record keeping." Aon also agreed to create a Compliance Committee of its Board of Directors to monitor compliance with these standards of conduct and review all complaints from insurance companies related to them.⁵

On September 2, 2009, it was announced that the pharmaceutical company Pfizer had agreed to pay \$2.3 billion to settle civil and criminal charges that it had illegally marketed a pain-killer drug. This was reported to be the largest health-care fraud settlement in history. In addition to agreeing to pay this extraordinary sum, and to having a subsidiary plead guilty to a criminal charge of violating the U.S. Food, Drug and Cosmetic Act, Pfizer entered into a comprehensive agreement with the government obligating the company to:⁶

1. maintain a Compliance Committee of senior executives;
2. require business leaders to annually certify their compliance with applicable sales and marketing rules (an extension of the Sarbanes-Oxley certification practice to broader compliance issues);
3. enforce a Code of Conduct reflecting "Pfizer's commitment to full compliance with all Federal health care program requirement"; and
4. require employees and designated third parties to certify their compliance with the Code.

The agreement further specifies that the Chief Compliance Officer "shall not be, or be subordinate to, the General Counsel or Chief Financial Officer." The Office of Inspector General of the Department of Health and Human Services previously had expressed its skepticism about a compliance officer's being part of an organization's legal department because of the perceived "conflict of interest" between the role of in-house counsel to protect and defend the organization, and the independence demanded of an effective compliance officer. The government now appears intent on translating this concern into a mandate.

In 2004, the Justice Department argued that a company's "non-existent or insufficient" compliance programs can help demonstrate the recklessness needed to establish violations of the federal False Claims Act.⁷ Also, a federal district judge has used the defendants' failure to implement an adequate compliance program to support their lengthy sentences for fraud. The court compared the compliance program at the defendants' medical device company to the compliance program elements of the FSGO and concluded that it came up well short. Among other things, the defendants' chose the compliance officer knowing that they could "manipulate and dominate" him.⁸ In 2007, federal prosecutors raised the stakes even further for compliance programs and compliance officers. They filed a civil complaint against the former Deputy General Counsel and Corporate Integrity Program Director of Tenet Healthcare for violating the False Claims Act.⁹ The complaint alleged that she had filed false certifications that the company was in full compliance with its obligations under a Corporate Integrity Agreement, despite knowing that one of its hospitals was in violation of federal regulations.¹⁰

[2] Deferred Prosecution and Non-Prosecution Agreements

In the aftermath of the scandals, litigation and prosecutions involving Enron, Arthur Andersen and WorldCom, the federal government dramatically intensified its use of two weapons in the war on corporate crime—the deferred prosecution agreement and the non-prosecution agreement. Dozens of companies, in a wide range of industries, have entered into such agreements in just the last five years. The use of this process was actually encouraged by the

Thompson Memorandum,ⁿ¹¹ which gave prosecutors the authority and flexibility to forego formal prosecution of an organization when the company acknowledged responsibility for wrongdoing, cooperated with the government and agreed to strengthen internal controls and compliance.

Under a deferred prosecution agreement, the DOJ files charges against the organization but agrees to defer prosecution, often for a year or two. In return, the company admits wrongdoing, agrees to cooperate, makes a substantial financial payment and carries out a series of tasks or "undertakings" during this period. If the company complies with the terms of the agreement, generally as determined by an independent monitor, the charges are dismissed. If not, the DOJ can prosecute, armed now with the company's admission.

In a variation of this agreement--the non-prosecution agreement--the government does not file charges at all, in return for the company's similar acceptance of responsibility and willingness to implement the undertakings.

While the tasks in each agreement reflect the specific charges and issues in the case, the list of undertakings invariably includes more general corporate governance and compliance-related provisions such as codes of conduct. The government's insistence on these provisions--coupled with the company's acceptance of them as a means of preserving its future--may be the best evidence of all that compliance programs, including codes of conduct, will prevent organizational wrongdoing.

Several deferred prosecution agreements reflect this acceptance. In one illustrative case, Bristol-Myers Squibb entered into a Deferred Prosecution Agreement with the Office of the U.S. Attorney for the District of New Jersey. The government agreed to defer prosecution for securities fraud for two years, during which time Bristol-Myers Squibb would continue to undertake "extensive reforms and remedial actions." These actions included creating the position of Chief Compliance Officer and "providing an effective mechanism in the form of a confidential hotline and email address" for employees to report concerns. The company also agreed to "establish and maintain a training and education program, which shall be reviewed and approved by the Board of Directors, designed to advance and underscore the Company's commitment to exemplary corporate citizenship, to best practices of effective corporate governance and the highest principles of integrity and professionalism, and to fostering a culture of openness, accountability and compliance throughout the Company." Compliance with the terms of the agreement, as determined by an outside monitor, resulted in the dismissal of the charges on June 14, 2007. At the time, the monitor noted the following developments:ⁿ¹²

- "The reformation of the company's corporate culture into one that embraces and endorses a commitment to compliance, ethics, integrity and excellence"
- "The ongoing development of an outstanding global compliance program, whose policies, processes and procedures are designed to ensure a culture of integrity and ethics"

In a demonstration of the power afforded to monitors under these agreements, in the Bristol-Myers Squibb case the monitor forced the company to remove its CEO and general counsel during the pendency of the deferred prosecution agreement because of the monitor's view that the CEO had involved the company in an improper business relationship with another organization.

On August 29, 2005, the DOJ announced a striking, and much-anticipated, deferred prosecution agreement with KPMG. This is the same matter that resulted in the court decisions challenging the application of the Thompson Memorandum against individual defendants, noted above. In return for the deferral of prosecution, the accounting firm (i) admitted that it--and its employees--had engaged in fraud, (ii) accepted permanent restrictions on its business practices, (iii) agreed to install an independent monitor for three years, (iv) pledged its full and active cooperation to the government, and (v) agreed to pay \$456 million in fines and restitution. As part of its pledge of cooperation, KPMG agreed not to assert any claim of privilege "as to any document, records, information, or testimony."ⁿ¹³ Moreover, "in addition to the

remedial actions taken to date, KPMG shall implement and maintain an effective compliance and ethics program that fully comports with the criteria set forth in Section 8B2.1 of the United States Sentencing Guidelines."

In a twist to these agreements, the Justice Department announced a settlement with Prudential Financial in which the company's general counsel, instead of an outsider, was designated to serve as the "monitor" of compliance with the substantive terms of agreement. Prudential's General Counsel must "make periodic reports to the Prudential Board of Directors Audit Committee as to the appropriateness and effectiveness of the compliance plan" and must also "provide the reports to the United States Attorney in the District of Massachusetts, along with a certification that the reports include all material information bearing on the effectiveness of the compliance plan."¹⁴

In 2008, in response to criticism the lack of objective guidelines for the use of monitors in connection with deferred-prosecution and non-prosecution agreements, the Justice Department issued the Morford Memorandum (named after the then Acting Deputy Attorney General).¹⁵ It established nine principles to "control the selection and use of monitors." The principles address the qualifications, selection and duties of corporate monitors and require that each U.S. Attorney's Office create a committee of prosecutors to help manage this process.

The Morford Memorandum states that a monitor's primary responsibility is to assess an organization's compliance with the agreement "including, in most cases, evaluating (and where appropriate proposing) internal controls and corporate ethics and compliance programs." This is because one of the causes of corporate misconduct is "the failure of internal controls or ethics and compliance programs to prevent, detect and respond to ... misconduct."¹⁶

In 2009, the Government Accountability Office (GAO) reported preliminarily on a study to assess how federal prosecutors decide whether to drop an investigation, prosecute a case or enter into a deferred-prosecution agreements or non-prosecution agreement. The GAO concluded that the three most frequently-cited factors in this decision are the company's cooperation, the collateral consequences of a prosecution and any remedial measures the company has taken. The GAO found that 45 of the 57 agreements it reviewed included requirements that the company institute or improve an ethics or compliance program.¹⁷

Prosecutors continue to use deferred-prosecution and non-prosecution agreements, complete with compliance program requirements, as the government seeks to reform corporations suspected of wrongdoing without triggering the collateral consequences of full-scale indictment and prosecution. Organizations not subject to such an agreement may want to conduct "internal" monitoring of their ethics and compliance programs, much as an external monitor would, to determine how well their programs measure up against the government's expectations and against compliance best practices.

[3] The FAR Rules

The obligation to have a code of conduct, as part of a system of internal and compliance controls, was extended to a wide range of organizations by rules adopted in late 2008 by the Department of Defense, the General Services Administration and NASA. These agencies amended the Federal Acquisition Regulation (FAR) to require most government contractors to have written codes of business ethics and conduct and to make them to every employee involved in performing the contractors' duties under contracts with the government. In addition, contractors must "exercise due diligence to prevent and detect criminal conduct ... [and o]therwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."¹⁸ Contractors must make disclosures to the government whenever they have "credible evidence" that an employee, agent or subcontractor has committed "a violation of Federal criminal law involving fraud, conflict of interest, bribery or gratuity violations" or a violation of the False Claims Act.

All but the smallest government contractors and those involved in contracts for commercially available items must also implement a Business Ethics Awareness and Compliance Program and Internal Control System. This system must

include an internal reporting mechanism such as a confidential hotline, procedures to ensure timely discovery of improper conduct and policies providing for prompt corrective measures.

With the exception of the mandatory disclosure provisions, these rules are not likely to trouble the members of the Defense Industry Initiative and other large companies that, as noted above, have had qualifying compliance programs for many years. However, other companies--both public and private--have much work to do to meet these requirements. These simple but sweeping requirements will apply to any company--public or private, foreign or domestic, large or small--that falls within this category, and their biggest impact may be on the *thousands* of smaller companies that do business with the federal government but do not already have comprehensive compliance programs.

[4] Companies Act on Their Own

Actions taken by two of the largest companies in the world--Boeing and Siemens--illustrate the far-reaching consequences of companies' enforcement of their codes of conduct even absent a government investigation.

Following an internal investigation, in 2005, Boeing's Board of Directors asked for--and received--the resignation of its CEO Harry Stonecipher after finding that his actions during the course of an affair with a female executive at the company were "inconsistent with Boeing's Code of Conduct."¹⁹ The investigation initiated by the Board had concluded that the relationship was consensual, had no impact on the company's business and did not influence either the career or the compensation of the female executive. Nevertheless, the Board concluded that "the CEO must set the standard for unimpeachable professional and personal behavior." The circumstances surrounding the affair included the CEO's use of the company's computer system to send personal emails. This investigation was initiated by an anonymous complaint to the chair of the Board of Directors.

In 2006, a successor to Stonecipher, Boeing CEO Jim McNerny, publicly stated, in the face of the earlier scandal as well as regulatory and enforcement actions involving his company, that Boeing was taking significant steps to turn "ethics and compliance into a competitive advantage for us." On September 26, 2007, the Boeing chief financial officer told the Oklahoma Business Ethics Consortium that "we are integrating integrity and ethics in everything we do. They are every bit as important as our financial performance ... A leader who delivers results without reflecting Boeing's ethical values won't remain a Boeing leader for long. It's my expectation that Boeing employees will play hard and fair."²⁰

On October 4, 2007, Siemens, the German-based multinational, announced that German authorities had fined the company almost \$300 million to resolve an investigation into embezzlement, bribery and tax evasion. In 2009, the company entered into the first billion-dollar settlement of anti-bribery charges with the U.S. Department of Justice and the SEC. Siemens has done more than just write these huge checks to government agencies, In the wake of these problems, Siemens took a number of steps to strengthen its compliance and ethics program, including:

- constituting a new Compliance Committee of its Board;
- appointing an outside lawyer to act as the independent "ombudsman" for employees to contact to raise questions or report violations;
- reorganizing its office of corporate compliance;
- adopting a new policy on corruption;
- establishing a formal program of anti-corruption and other legal compliance training for management, group and regional compliance officers, and other employees'; and

- engaging an "independent compliance advisor" to recommend further improvements and make periodic reports to its board of directors.

There can no longer be any question that ethics and compliance programs must command the attention of the management of every company regardless of industry, size or regulatory environment. Taking the necessary steps before being forced to do so by a public scandal or a regulatory enforcement action can go a long way toward protecting a company from the catastrophic consequences that compliance failures can have for companies that have not dedicated the necessary resources to a compliance program anchored by a suitable code of conduct.

Legal Topics:

For related research and practice materials, see the following legal topics:

Administrative Law Agency Investigations General Overview Business & Corporate Law Corporations General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law U.S. Securities & Exchange Commission Administrative Proceedings General Overview

FOOTNOTES:

(n1)Footnote 1. DOJ Opinion Procedure Release No. 04-02 (July 12, 2004), *available at* <http://www.justice.gov/criminal/fraud/fcpa/opinion/2004/0402.html>.

(n2)Footnote 2. OFHEO News Release, *OFHEO Announces Supplemental Fannie Mae Agreement* (Mar. 8, 2005), *available at* <http://www.fhfa.gov/webfiles/2160/030805agreementrelease.pdf>.

(n3)Footnote 3. *See* Consent Order, In the Matter of the Federal National Mortgage Association, U.S. Office of Federal Housing Enterprise Oversight, Order No. 2006-1, *available at* <http://www.fhfa.gov/webfiles/941/attachsettlement.pdf>.

(n4)Footnote 4. SEC Release No. 33-8569, In the Matter of The Coca Cola Company (Apr. 18, 2005), at 10, *available at* <http://www.sec.gov/litigation/admin/33-8569.pdf>.

(n5)Footnote 5. Aon Press Release, *Aon Settles Investigations by Five Agencies in Three States* (Mar. 4, 2005), *available at* <http://www.aon.com>.

(n6)Footnote 6. *See* Corporate Integrity Agreement between the Office of Inspector General of the Department of Health and Human Services and Pfizer, Inc., *available at* www.oig.hhs.gov/fraud/cia/agreements/pfizer_inc.pdf.

(n7)Footnote 7. *U.S. v. Merck-Medco Managed Care*, 2004 U.S. Dist. LEXIS 23431 (E.D. Pa. 2004) .

(n8)Footnote 8. *U.S. v. Caputo*, 456 F. Supp. 2d. 970, 984 (N.D. Ill. 2006) .

(n9)Footnote 9. *See* Complaint, *U.S. v. Sulzbach*, No. 07-61329 CIV-MARRA, 2007 WL 5078620 (S.D. Fla., Sept. 18, 2007).

(n10)Footnote 10. *U.S. v. Sulzbach*, Civ. No. 07-61329, 2008 U.S. Dist. LEXIS 30949 (S.D. Fla., September 18, 2007).

(n11)Footnote 11. *See* § 13.02[2][g][ii] above.

(n12)Footnote 12. *See* Monitor's Executive Summary to the U.S. Attorney, *available at* <http://www.justice.gov/usao/nj/press/files/pdf/ExecutiveSummaryofFinalReportofMonitor.pdf>.

(n13)Footnote 13. KPMG-Deferred Prosecution Agreement (Aug. 26, 2005), *available at*

<http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20dp%20AGMT.pdf>.

(n14)Footnote 14. See Press Release, Michael J. Sullivan, United States Attorney, District of Massachusetts, August 28, 2006.

(n15)Footnote 15. See Morford, C., Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations (March 7, 2008) (the "Morford Memorandum"), available at www.justice.gov/dag/morford-useofmonitorsmemo-03072008.pdf.

(n16)Footnote 16. *Id.*, Morford Memorandum, at 5.

(n17)Footnote 17. See Preliminary Observations on DOJ's Use and Oversight of Deferred Prosecution and Non-Prosecution Agreements, Statement of Eileen R. Larence, Director, Homeland Security and Justice, GAO, Before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, House of Representatives, GAO Report-09-636T (June 25, 2009), available at <http://www.gao.gov/new.items/d09636t.pdf>.

(n18)Footnote 18. See FAR Case 2007-006, *Contractor Business Ethics and Compliance Program and Disclosure Requirements*, 73 *Fed. Reg.* 67064 (Nov. 12, 2008), amending 42 C.F.R. § 52-203.13.

(n19)Footnote 19. Boeing News Release, *Boeing CEO Harry Stonecipher Resigns; Board Appoints James Bell Interim President and CEO; Lew Platt to Expand Role* (Mar. 7, 2005), available at http://www.boeing.com/news/releases/2005/q1/nr_050307a.html.

(n20)Footnote 20. See "CFO says ethics become priority at Boeing," *Tulsa World*, September 27, 2007, available at http://www.tulsaworld.com/TWPDFS/2007/Final/W_092707_E_1.pdf.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.09

AUTHOR: Jay M. Cohen

§ 13.09 Creating and Demonstrating a "Culture of Compliance"

Before turning to the task of drafting a new code of conduct or revising an existing one, corporate counsel and compliance officers should consider their organization's "culture of compliance." Increasingly, regulators are looking for evidence that an organization not only has the right process, but also that it has the right culture. As former SEC chairman William Donaldson stated, "[c]reating an ethical culture means instilling and maintaining a commitment to do the right thing, this time and every time--so much so that it becomes entwined in the essential DNA of the [organization.]" In a speech to the Bond Market Association in April 2005, he offered his views on what it takes to create and demonstrate this culture:

The [organization's] leadership must, of course, set the right tone at the top, but this culture can't be limited to senior management, the compliance department, and the aspirational wording of a corporate mission statement. The culture must be learned, reinforced and shared by each and every employee. The firm must develop in its employees the courage and commitment to question whether a particular course of ethical conduct is truly ethical, or is truly in the best interests of clients and customers--even in the absence of specific rules, and even when the competitor chooses a different course.¹

Two of Mr. Donaldson's former colleagues at the SEC add substance and specificity to what might otherwise be an element that is impossible to evidence or measure. The former Director of the SEC's Office of Compliance Inspections and Examinations listed these "concrete steps that firms might take to instill, in a meaningful and lasting way, a strong culture of compliance:"²

- Establish and communicate an ethical "tone at the top".
- Provide effective employee training.
- Emphasize compliance over profits.
- Establish strong policies and procedures to prevent and detect violations.

- Test for compliance.
- Deal with problems quickly and appropriately.
- Implement a superior compliance program that has the "resources, respect and access" it needs.
- Empower employees to question conduct.
- Report problems to senior management and the board.
- Self-assess honestly and periodically.
- Engage in long term thinking.
- Keep your regulator informed.

Stephen Cutler, the former Director of the SEC's Enforcement Division, offered his own ideas on the elements of a "culture of compliance" in a 2004 speech to the General Counsel Roundtable that every corporate counsel and compliance officer should read:³

- "From an employee's first day on the job, he should know that ethics and honesty are important to the company."
- "Whenever your CEO is delivering a state-of-the-company address or is offering remarks to company employees, she should be talking about the company's values as well as its profits."
- "Make clear that retaliating against or threatening whistleblowers will not be tolerated."
- "Make integrity, ethics and compliance part of the promotion, compensation and evaluation processes."
- "Make clear that you won't tolerate compliance risks-even if that means losing a lucrative piece of business."
- "Ethics and compliance should be part of your regular education and training efforts."

Another measure of a company's compliance culture, according to Mr. Cutler, is how it responds to violations:

- "Hold your managers accountable. That means disciplining or even firing them when they have failed to create a culture of compliance."
- "Let employees know that no one at the company is above the law; that no matter how important or how senior, someone who has violated an ethical standard will be punished."
- "And as much as possible (and consistent with privacy concerns), the punishment and the reason for it should be clear to the company's other employees."

Equally important as these expectations of regulators, research by the Ethics Resource Center indicates that creation and maintenance of the right compliance culture can have as much if not more favorable impact on an organization's compliance performance as the implementation of compliance processes and tools.⁴

These specific steps and important messages can and should be built into the code of conduct, which will then serve as both the foundation and the support for the compliance culture and processes in an organization. The discussion which follows, and the sample code in Appendix 13-C, will show you how to do this.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral Overview

FOOTNOTES:

(n1)Footnote 1. SEC Chairman William H. Donaldson, Remarks Before the Bond Market Association (Apr. 20, 2005).

(n2)Footnote 2. Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, Remarks Before the National Society of Compliance Professionals 2004 National Membership Meeting, at III (Oct. 28, 2004), *available at* <http://www.sec.gov>.

(n3)Footnote 3. Stephen M. Cutler, Director SEC Enforcement Division, Speech at the Second Annual General Counsel Roundtable, Tone at the Top: Getting it Right (Dec. 3, 2004), *available at* <http://www.sec.gov>.

(n4)Footnote 4. National Business Ethics Survey (2005), Ethics Resource Center, *available at* www.ethics.org.



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.10

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§ 13.10 Having the Right Code

[1] Creating or Reviewing Your Code

We have seen that regulators, prosecutors, courts and the public have all weighed in on the need for organizations to strengthen their efforts to promote ethics and integrity. Most have urged organizations to make a code of conduct the centerpiece of these efforts. Regulators have even provided settlements, mandates, or just good guidance to illustrate what should be in this code. A variety of other resources are readily available to inform this process and provide advice and examples regarding the structure and substance of the code.

Against this backdrop, every organization should be considering whether to adopt a new code of conduct, or to review and improve an existing one. If a company already has a code of conduct, it should be reviewed at least annually, to address changes in applicable laws and regulations and to keep up with changes in its business model and activities. If a company needs to create a code, there are a number of preliminary steps to take and questions to answer before the actual drafting of the code begins. Either way, the goals for the code must be kept in mind.

Organizational codes of conduct serve to set expectations and standards, provide information and guidance about those expectations and standards, and offer resources to help individuals understand and meet them. These goals will not be met simply by parroting the requirements from the relevant regulator, or borrowing a code from some other organization or expert. Instead, it will take careful consideration and appropriate answers to the questions below--answers that reflect a combination of regulatory mandates, industry issues, "best practices" and the unique culture and business of an organization.

[a] Who Will Draft or Review the Code?

The first issue is who will be responsible for drafting or reviewing the code. Organizations often use legal or compliance staff for this purpose. These personnel are usually the most well-informed about both the general legal and regulatory requirements for the code and about the specific issues that must be addressed based upon the organization's business and regulatory environment. They can then vet the code draft with management, communications experts and other staff (such as line employees) to help ensure that the code is comprehensive, understandable and adequately addresses the concerns of supervisors and employees.

Some organizations have established drafting committees with representatives from legal, compliance, human resources, internal audit, corporate communications, marketing and key business units. The committee approach can make it easier to identify compliance-related issues and concerns from around the organization and make the code-drafting project a more high profile and collaborative process, one that the business side of the organization has an investment in from the beginning. It can help ensure that the code is consistent in tone, style and substance with other corporate policies and communications.

[b] What Resources Can the Drafters Call Upon?

Organizations can reach out to a variety of outside experts for direct assistance in designing and implementing an effective code. There are many external resources to assist drafters of the code, including the ones we reviewed earlier in this chapter. For example, there are professional organizations devoted to ethics and compliance issues such as the Ethics & Compliance Officer Association ("ECO"),ⁿ¹ the Society for Corporate Compliance and Ethics ("SCCE")ⁿ² and the Ethics Resource Center ("ERC").ⁿ³ These organizations have experts on staff who have helped organizations draft codes of conduct, and they also provide other resources including how-to books and articles, conferences at which key compliance-related subjects are addressed and access to organizational compliance and ethics officers who are their members. One organization--the Ethisphere Council--rates codes of conduct using 43 elements to reflect eight "critical components"--public availability; tone at the top; readability and tone; non-retaliation; commitment to stakeholders; risk topics; learning aids such as questions and answers; and presentation and style. Each of these components is reflected in the sample code.ⁿ⁴

In addition, there are industry-specific organizations providing similar resources. These include the DII, the Health Care Compliance Association ("HCCA"),ⁿ⁵ the Compliance and Legal Division of the Securities Industry and Financial Markets Association ("SIFMA")ⁿ⁶ and the National Defense Industry Association ("NDIA").ⁿ⁷

There are many internal resources in any organization, so one key step in the process, before drafting starts, is to inventory existing company policies and procedures that may address the legal and compliance risks that the code is most likely to cover. Organizations are often surprised to find out that, even in the absence of a "code of conduct," they already have a great number of policies and procedures related to compliance issues. These may be found in employee handbooks, human resources manuals, business unit procedures, informal practices, free-standing policies and communications, and a wide variety of other places.

Finally, the sample code reproduced in Appendix 13-C to this chapter can help an organization identify key issues and develop an effective means of addressing them. This sample code meets the requirements of the NYSE listing standards, as well as Section 406 of the Sarbanes-Oxley act and related SEC rules. The sample code has been designated a "best practices" code by the Ethisphere Council, with an overall A rating, placing it in the top two percent of all codes reviewed by that organization. It is intended to apply to each employee in the organization, regardless of job responsibility, and thus its structure and provisions can be useful models for organizations in any industry. In the subsequent discussion of drafting and structuring a code of conduct, we will refer frequently to the sample code.

[c] What Kind of Code Should It Be?

An important consideration is whether the code will be a high-level statement about the organization's mission, values and principles, or whether it will also include references to, and even details about, more specific policies and procedures? Is this a "code of ethics," a "code of conduct," or some of both? There can be a difference.

Codes of ethics, at least until the Sarbanes-Oxley Act, were generally expected to be shorter, focusing on fundamental corporate values such as fairness, honesty and integrity, and offering some guidance on how these values impact the daily activities of the organization and its employees. According to the Ethics Resource Center:

A code of ethics serves as a central guide to support day-to-day decision making at work. It clarifies the cornerstones of your organization--its mission, values and principles--helping your managers, employees and stakeholders understand how these cornerstones translate into everyday decisions, behaviors and actions.⁸

Organizations with "ethics" codes often include links or references to other source material for more specific policies and procedures.

Codes of conduct tend to include these ethics concepts while at the same time adding additional, more factual information about specific policies, compliance issues and acceptable (or unacceptable) actions regarding these issues. These codes are not legalistic; they should not read like the criminal law or a manual from a regulator, but they should state expected behaviors in the areas that they cover.

Section 406 of the Sarbanes-Oxley Act and the related rule-making from the SEC and the stock exchanges contain elements of both types of codes, mixing references to "honest and ethical conduct" with sections related to particular issues like conflicts of interest and the integrity of financial disclosures.⁹ That is why a code combining ethics and values on the one hand with rules of conduct on the other may now make the most sense. After all, organizations choosing to have "aspirational" ethics codes will still have to find a way to address the more specific obligations under these rules.

The DII model reflects the merging of values and rules into one code. The sample code takes this same tack by including references to fundamental organizational values as well as more practical guidance on the kinds of issues that are most likely to arise in the organization and that are expected by the regulators to be addressed in the code. This approach takes advantage of the communications, training, and interest around the adoption of the code to give employees information and assistance that can be useful in their jobs day-to-day, and that will help them identify and understand some of the specific rules that they are obligated to comply with. It makes the code more than just a series of generalities, instead instructing employees with far greater clarity about what to do in key situations.

No code can, or should, contain all of the policies and procedures in the organization. In some instances, such as with employment-related issues, the code can set forth basic rules about workplace conduct and security, while an employee handbook or human resources manual contains more technical and specific rules and procedures. Also, different business units or administrative areas will still need their own policies and procedures.

For example, the code can set forth the obligation of all employees to maintain accurate books and records, while the finance and accounting departments have their own policies and procedures to meet this obligation. The code of conduct for a publicly-traded company should include the prohibition against insider trading and then refer to more detailed policies and procedures to help address this issue. The sample code is an example of how this is done. Likewise, the code of conduct for a financial services company should make clear the duty of all officers, employees, directors and agents to treat customers fairly. More specific manuals and codes in a financial services organization will detail how investment advisors, financial professionals and other specialized staff must achieve this objective.

In another example, the OIG recommends that organizations supplement their "standards of conduct" with "a comprehensive set of written policies addressing all applicable statutes, rules and program instructions that apply to each function or department." These procedures for relevant legal and business risk areas should "articulate specific procedures personnel should follow when performing their duties."¹⁰ In these cases, organizations often provide references or links in their general codes of conduct to the more specific and detailed policies.

[d] What Style Should Be Used?

As with all issues around the drafting of the code, it is critical that it reflect the organization's culture, management style

and operations. The code must fit right in with the way the organization is run, and not stand apart as overly legalistic in an organization where policies and directives are generally short and straightforward, or overly simplistic in an organization that otherwise likes to spell out expectations and responsibilities in great detail.

The sample code provides a structure and style that can be adapted for either type of organization. The substance of this code, while providing considerable information about compliance-related responsibilities and expectations, is written in concise and conversational language. The format is readable, with frequent breaks in the text as well as relevant questions-and-answers, and it is made even more user-friendly through the incorporation of color and other visual aides.

The key is to remember the purpose of the code and its audience: this is not a legal brief for courts or regulators but a means of communicating critical legal and compliance concepts to non-lawyers of varying levels of education and experience. It is also the primary means of "selling" compliance and its importance to everyone connected with the organization. That is why the corporate communications and marketing departments can be valuable partners in marketing the code, as members of a drafting committee or otherwise in helping to review, distribute and publicize the code. Some companies have turned to groups of employees and executives--either informally or through focus groups--to test the clarity of the concepts and the relevance of the examples in their codes.

[e] Who Will be Covered by the Code?

Another question that companies must answer, after deciding what kind of code they want, is who will it cover--officers, directors, employees, agents, contractors, suppliers, consultants, etc? Will there be different codes for different groups of people depending on their title, location, function or employment status? The answers to these questions will depend, in part, on industry norms and regulations. Nonetheless, to the extent that the values and rules in the code reflect the most important issues faced by the organization, the code can--and should--apply to the broadest range of individuals as possible. Both the NYSE and NASDAQ want the codes for their listed companies to apply at least to all directors, officers and employees. This has the advantages of consistency, clarity and a common set of expectations and norms, from the top of the organization on down.

Many companies go even further. For example, the Wal-Mart Statement of Ethics expressly applies to third parties:¹¹

Wal-Mart expects its suppliers, consultants, law firms, public relations firms, contractors and other service providers to act ethically and in a manner consistent with this Statement of Ethics. If you hire a service provider, you should take reasonable steps to ensure that the service provider is aware of our Statement of Ethics, has a reputation for integrity and acts in a responsible manner consistent with our standards.

In the Pfizer settlement discussed above, the government insisted that the company send its code to all "third-party personnel" working for other organizations who help Pfizer promote the products covered by the agreement. This is a critical issue for organizations and their compliance programs. A company can delegate functions to these third parties, but it cannot delegate the legal and regulatory responsibility for how those functions are carried out. In addition, these third parties have the company's reputation and brand in their hands. Companies need to know who they are doing business with, and how that business is being conducted on their behalf.

Of course, if organizations are going to apply their codes to groups of non-employees--such as suppliers and vendors--they better make sure that those third parties know what is expected of them. A survey conducted in 2004 by Deloitte and *Corporate Board Member* magazine found that 90 percent of the responding companies apply at least part of their codes to such outside groups, but only 52 percent of respondents actually distribute the code to such parties.¹²

Related to this issue is the question we raised in connection with the SEC rules for Section 406 of the Sarbanes-Oxley Act--one code or two? As noted above,¹³ because the SEC has made clear that the duty to disclose amendments to and

waivers of the code is limited to the subject-matter and officers covered by its rules, organizations can adopt one, comprehensive code without fear of having to make a public disclosure every time that they change something in it that is unrelated to these rules.

[2] Structure of the Code

A number of important subjects should be covered in any code of conduct, regardless which type and style are chosen in an organization. These include a leadership letter; purpose and goals; core mission and values; information about the compliance program and resources, including any reporting mechanisms; the protection of employees and agents against retaliation for reporting concerns; every individual's accountability for compliance; and the consequences of non-compliance. Each of these sections is included in the sample code in Appendix 13-C.

[a] Statement from Leadership

An introductory letter or statement from the Chief Executive Officer will explain the importance of ethics and compliance to the organization. This statement should articulate the personal, as well as institutional, commitment of senior management and the board of directors to ethical business practices and regulatory compliance. This sets the "tone at the top" and makes clear that ethics and compliance are part of the "culture" of the organization. The code, and the entire compliance program, will benefit from this emphasis. Not only is this stated commitment necessary for the rest of the employees to take these issues seriously, but regulators increasingly expect to see this kind of tangible demonstration by the leaders of the organization of their accountability and responsibility for compliance.¹⁴

The sample code includes a letter from the President and CEO explaining the importance of integrity and ethical business conduct to the business success and reputation of the organization, and summarizing the role of the code in promoting such conduct. He reminds employees of "the responsibility of each of us" to uphold the values and principles reflected in the code.

[b] Purpose and Goals

An introductory section should set forth the purpose and goals of the code of conduct and the overall compliance program, and also explain which populations within the organization are covered by the code. This section should emphasize the commitment of the organization--and the obligation of everyone connected with it--to comply with all applicable laws and regulations.

The sample code expresses this commitment in terms of the organization's stakeholders including its customers, employees, business partners, shareholders and the communities in which the organization operates.

[c] Mission and Values

The organization's mission and values should be described in clear language. This section could include "ethical" values such as integrity, respect and fairness, together with "business-related" principles like commitment to customers, quality and service excellence. It serves to put the code in the context of the organization's overriding principles and goals and helps explain how compliance with the code will contribute to these goals. This section might even include practical examples of how to put these principles and values to work in meeting customers' needs or dealing with fellow employees.

For example, the sample code includes a discussion of the organization's *Mission, Vision, Values and Ethical Standards*. Employees are told that "this Code of Ethics provides you with practical guidance to apply these values and ethical standards in your everyday activities, and with resources to call upon if you have questions or concerns."

The introduction to the sample code adds that "everything we say and do must reflect our values and ethical standards."

[d] The Compliance Program

This section should describe the compliance program, including the resources available to employees with questions or concerns about ethics and compliance issues, thereby demonstrating the organization's financial and staffing commitment to compliance and giving employees greater comfort about raising issues internally. The section typically includes references to the compliance officer and staff, any executive or board oversight committees, and available training or other communications and materials about the program.

The sample code contains a separate section, entitled *Asking Questions and Raising Concerns*, with a list of Compliance Resources and Reporting Tools, including the Compliance Helpline, and a separate means of directly contacting the Board of Directors. Instructions for using the Helpline are provided for people calling from outside the United States.

This section of the sample code also gives employees a set of questions to ask themselves "when faced with a difficult ethical decision or a situation that might be improper?" Employees are encouraged to seek guidance before acting if they have even the slightest doubts.

[e] Internal Reporting Mechanisms

As part of the description of the compliance program, employees should be told about the means for requesting guidance or reporting concerns. Codes may suggest that employees consult with supervisors and internal resources such as human resources and the legal or compliance staff. In addition, it is becoming increasingly common for organizations to maintain 1-800 numbers--called compliance "hotlines" or "helplines"--for employees to use if they are uncomfortable raising issues in these other ways, or if they are unsatisfied with the response they receive regarding their concerns. The phone lines, which may be answered by compliance staff or by external vendors, also serve as an anonymous reporting mechanism, giving organizations a means of complying with Section 301 of the Sarbanes-Oxley Act, regarding "confidential, anonymous" complaints to the audit committee about financial and accounting matters.¹⁵ Companies may also provide dedicated email addresses, web-based reporting tools or mail drops for these communications and make these mechanisms available to customers and other external stakeholders, in addition to employees. It is advisable to provide employees with multiple means of reaching the Compliance Officer--by hotline, dedicated email, letter, or phone call--to encourage as many employees as possible to come forward and ask for help or report concerns.

A number of companies have created an independent--but internal--ombuds office to serve as a neutral and impartial recipient of questions and complaints, as well in some instances as a mechanism to resolve disputes. These companies generally have a headquarters ombuds staff that is reinforced by part-time, local resources scattered throughout business units and geographic locations. The central staff typically operates outside the ordinary line management of the organization but has access to managers and employees at all levels. The goal is to provide resources across the organization to help interpret the code of conduct and other compliance policies, provide guidance on the application of these rules, refer employees to the right resources to handle their problems, and make sure that matters are promptly and effectively addressed.

Companies with operations in Europe must take into consideration actions by regulators in the European Union regarding compliance hotlines. In 2005, French data protection authorities rejected applications by two U.S. multi-national companies to operate such hotlines in France, concluding that data protection laws placed limits on the use of such hotlines for processing information about company employees and for accepting anonymous complaints. Since then, both the French authorities and the European Article 29 Working Party--the advisory group that includes representation from the 25 data protection authorities in the European Union--have issued guidance to help companies implement compliance hotlines in these countries.¹⁶ These documents and similar guidance from other EU member states place limits on the use of these hotlines, but they also provide roadmaps for companies to implement and communicate about them.¹⁷ In a related action, a labor court in Germany ruled that Wal-Mart's proposed hotline violated local labor laws and had to be negotiated with its employees.¹⁸

Organizations must record and track all communications through these vehicles, and establish procedures to investigate the matters and report the results of these investigations back to the individuals who initiated the communications. These reporting mechanisms are not only mandated by regulation, they are essential for an effective program. Research conducted by the Ethics Resource Center shows that employees are more likely to report misconduct--and thus help the organization respond quickly and prevent small problems from becoming large one--when all four of these compliance program elements are in place: written ethics and compliance standards, ethics training, a dedicated ethics office/advice line, and a means for employees and agents to report misconduct anonymously.¹⁹

The sample code in Appendix 13-C describes the available resources including the company's Compliance Helpline and its compliance team.

[f] Non-Retaliation

Every code of conduct must include a statement of the organization's policy protecting employees against retaliation or retribution for reports about compliance matters. This is critical to ensure that whistleblowers are protected in accordance with the Sarbanes-Oxley Act and other requirements. It is also in the organization's best interest to encourage employees to report these issues internally so that the organization has the first opportunity to evaluate and address them. Moreover, a decision by the United States Supreme Court has broadened the category of employment actions that can constitute prohibited retaliation--at least in the employment discrimination context--placing an additional premium on organizational efforts to prevent and identify any conduct that could be considered retaliatory.²⁰ Many companies now encourage, and some even require, employees to promptly report suspected misconduct. The internal reporting mechanisms described above²¹ can be used by employees for this purpose.

The section of the sample code entitled *Asking Questions and Reporting Concerns* describes the protection against retaliation, noting that "[w]e take claims of retaliation seriously... . We will not tolerate any retaliation against anyone who makes a report in 'good faith' (meaning that the person reporting has made a genuine effort to provide honest and accurate information even if the information later is proven to be mistaken.)"

[g] Personal Responsibility and Certification

The code provides an opportunity to make clear the personal responsibility of directors, officers, supervisors and employees for complying with the code and related standards of conduct. Organizations are increasingly including compliance factors--and ethics and integrity--in their performance evaluations, decisions on compensation and promotion and other employment-related decisions. If so, that should be mentioned in the code.

Companies now often insist that employees sign a certification or pledge, at the end of the code or as part of code-related training, indicating that they have read the code and intend to comply with it. This certification is generally done annually, although at some companies employees are required to complete this certification every three months, as part of a quarterly performance review process. A "typical certification" cited by the DII states:

I have read the [Code] and understand that it represents company policy. In addition, I understand that by signing my name below, I am certifying that I am familiar and will comply with the requirements and will report immediately any information concerning a violation or possible violation.²²

In some cases, this certification may also indicate that the employee has reported to the compliance office any known violations of the code of conduct or other relevant company policies.

The next-to-last section of the sample code, entitled *Our Personal Commitment*, advises that, "[o]nce a year, we will ask each employee, officer and director to record an individual commitment to compliance with this Code."

[h] Consequences of Non-Compliance

Together with personal responsibility, the code should explain the consequences of non-compliance. This discussion may include a summary of the organization's processes for investigating and disciplining compliance violations, and any other means by which everyone, throughout the organization, will be held accountable for compliance performance.

The sample code makes clear at the beginning that, "When you violate laws, regulations, ethical standards, or company policies, [we] will take disciplinary action, which could include termination of employment."

[3] Subjects in the Code

Organizations that choose to include business conduct issues in their codes, in addition to ethics and values, must next decide what subjects to cover, in addition to the sections we have just reviewed. This requires an analysis of more than just the regulations of the SEC and the stock exchanges; it also requires an assessment of each organization's specific legal and regulatory risks and issues. The assessment should reflect the nature and size of the business; industry regulations and concerns; the jurisdictions in which the organization does business, including any countries outside the United States; and any recent internal audits, investigations, regulatory actions or lawsuits. Code drafters need to consider what the organization hopes to accomplish--and needs to accomplish--by adopting this code: is it to comply with the relevant stock exchange listing standards or are there a number of other compliance issues to address and larger goals to achieve?

The sample code incorporates the requirements of the Sarbanes-Oxley Act and subsequent regulations from the SEC and the stock exchanges. It also covers a wide range of other subject areas that organizations of any size, in any industry, will likely have to address such as: treatment of employees, competition and antitrust, business gifts and entertainment, conflicts of interest, accurate books and records, use of company assets, insider trading, and protection of information about customers and employees. At the same time, while codes like the sample code and others from companies in the relevant industry will be very useful in the assessment of subject matter to cover, each code must reflect the organization's particular circumstances and goals. The committee approach described above can be helpful in making sure that all of the right issues and objectives are identified, by legal and business experts within the organization.

As demonstrated in the sample code, the various issues can be organized into broad categories so that the relevant policy for a particular subject is easy to find. The sample code groups these issues into three categories: *Fellow Employees*, *The Company and Its Resources*, and *The Marketplace*.

The Ethics Toolkit from the ERC has a comparable list of "common provisions found in organizational codes."²³ Similar subject areas are commonly covered in the codes of DII signatories.²⁴ These include: business courtesies (including gifts, services, meals, entertainment, hospitality, etc.); conflicts of interest; use of company resources; complete and accurate books and records; relationships with suppliers and agents; reporting misconduct within the company; inside information and insider trading; antitrust and restriction of trade; international business practices; workplace relationships and conduct; political contributions; corporate citizenship and community relations; quality of services and products; environmental compliance; and financial accounting and disclosure.

Within each category in the sample code are a number of policies on specific issues. These sections in the code generally include related policy statements, practical examples, sources of available guidance and, in a number of instances, questions and answers regarding likely compliance issues and representative situations to clarify those issues.

Other provisions need to be considered depending on the organization's business, industry, regulatory environment and location. For example, defense contractors generally include sections relating to government contracts, handling of classified information and the hiring of former government employees. Companies operating outside the United States

typically address foreign privacy and information policies, the Foreign Corrupt Practices Act and perhaps anti-boycott, trade, import and export laws. Financial services companies should be including anti-money laundering and privacy of customer information as subject areas in their codes of conduct. Manufacturing companies emphasize environmental compliance and health and safety policies, while pharmaceutical companies address compliance with regulations of the Food and Drug Administration.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act Securities Law Self-Regulating Entities General Overview

FOOTNOTES:

(n1)Footnote 1. For more information on the ECOA, *see* its website at www.theecoa.org.

(n2)Footnote 2. For more information on the SCCE *see* its website at www.scce.org.

(n3)Footnote 3. For more information on the ERC, *see* its website at www.ethics.org.

(n4)Footnote 4. *See* "Codes of Conduct Benchmarked," www.ethicsphere.com/43elements.

(n5)Footnote 5. For more information on the HCCA, *see* its website at www.hcca-info.org.

(n6)Footnote 6. For more information on the SIFMA, *see* its website at www.sia.com.

(n7)Footnote 7. For more information on the NDIA, *see* its website at www.ndia.org.

(n8)Footnote 8. *See* ERC Books, *Creating a Workable Company Code of Ethics--Excerpts from the 2003 Edition*, available at www.ethics.org.

(n9)Footnote 9. *See* discussion of Sarbanes-Oxley § 406 and related SEC implementing rules in §§ 13.03 and 13.04 above.

(n10)Footnote 10. *See* OIG Compliance Program Guidance for Medicare+Choice Organizations Offering Coordinated Care Plans, 64 Fed. Reg. 61896 (Nov. 15, 1999) .

(n11)Footnote 11. Wal-Mart Statement of Ethics at 2, available at http://media.corporate-ir.net/media_files/IROL/11/112761/corpgov/Ethics%20_Current.pdf.

(n12)Footnote 12. *See* Business Ethics and Compliance in the Sarbanes-Oxley Era, A Survey by Deloitte and Corporate Board Member Magazine (Jan. 23, 2004), available at www.boardmember.com/network/dt_ethics.pdf.

(n13)Footnote 13. *See* § 13.04[7] above.

(n14)Footnote 14. *See, e.g.*, speech by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, SEC, The Culture of Compliance (Apr. 23, 2003), available at www.sec.gov.

(n15)Footnote 15. *See* 15 U.S.C. § 78j-1(m)(4)(B).

(n16)Footnote 16. *See* Terwilliger, G.J., "E.U. Data Protection Laws," National Law Journal, May 22, 2006, page

18; *see also*, opinion of the Article 29 Working Party, *available at* www.ec.europa.eu/justice_home/fsj/privacy.

(n17)Footnote 17. *See* Lauer, S., "EU Data Privacy for Whistleblower Hotlines" (2008), *available at* <http://www.globalcompliance.com/pdf/eu-data-privacy-for-whistleblower-hotlines-variation-among.pdf>.

(n18)Footnote 18. *See* Taub, S., "Multinationals Find SOX is Conflicting with Local Laws," *Compliance Week* (July 19, 2005).

(n19)Footnote 19. Ethics Resource Center, The 2003 National Business Ethics Survey, *available at* <http://www.ethics.org>.

(n20)Footnote 20. *Burlington Northern & Santa Fe Railway Co. v. White*, 548 U.S. 53 (2006) .

(n21)Footnote 21. *See* § 13.07[2][e] *above*.

(n22)Footnote 22. DII 2006 Annual Report at 2, *available at* www.dii.org.

(n23)Footnote 23. *See* Ethics Toolkit, Common Ethics Code Provisions, *available at* www.ethics.org.

(n24)Footnote 24. *See* DII 2006 Annual Report, at 20-31, *available at* www.dii.org.



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Corporate Governance: Law and Practice

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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.11

AUTHOR: Jay M. Cohen

§ 13.11 Successfully Implementing the Code

[1] The Overall Compliance Program

As we have seen throughout this chapter, the code of conduct must be placed in the context of the overall compliance program that organizations are increasingly expected to (and are now deciding to) implement. The code may well be the foundation of this program, but it will not achieve its objectives without the other elements to make it known, understood, used, monitored, enforced and improved when necessary. In each of the compliance-related recommendations and mandates that we have reviewed, the code of conduct is expected to be reinforced by mechanisms to take it off the shelf, and out of the computer, and make it work throughout the organization.

It is not our goal in the remainder of this chapter to review in depth these additional elements of an "effective" compliance program. But before closing we would like to briefly discuss some of the other elements that should be included in your organizations compliance program to ensure that the code will have the necessary infrastructure and support to achieve its objectives. These programs are an effective combination of process and substance: process to incorporate the elements of the FSGO and the tools needed to impact behavior; and substance to address the substantive legal and compliance issues that are most important to the organization.

[2] Status and Resources--The Tone From the Top

[a] The Tone From the Top

Nothing is more critical to the success of a compliance program--and more essential to the creation of a compliance culture--than active and constant support from the top. It takes time and resources to write an effective code of conduct for an organization, and far more time and resources to make the code come alive in that organization. Companies that are serious about compliance must be willing to commit the resources to make this happen. Organizations must also give their compliance programs sufficient status and stature to persuade officers and employees to take the program seriously. One way to accomplish both objectives, used by many companies, is for the board of directors to formally adopt the compliance program, including the code of conduct, thus signifying its importance to senior management and the rest of the organization. According to the Conference Board, "ethics and compliance practices are a crucial component of corporate governance programs and should take center stage on board agendas." In this regard, boards

"should undertake responsibility for overseeing the process adopted to draft, update, and enforce a corporate code of business conduct."¹

Another way is to set and communicate the right tone from the top, as demonstrated by the answers to the following questions.

[b] Who Owns Compliance?

One key to an effective compliance program is clarity regarding the ownership of compliance and about the right division of responsibility for compliance-related activities. The Compliance staff cannot be the sole owners of the organization's legal and regulatory obligations. Instead, the Compliance Department should be responsible for the "pre" and "post" of compliance:

"Pre"--This means helping supervisors and employees identify, understand and address the significant legal and regulatory requirements associated with their part of the business. The code of conduct is the central element in meeting this responsibility.

"Post"--Compliance should organize efforts to check, from time to time, on how well business units and employees are doing at meeting these requirements.

It is critical that business leaders and their employees are held responsible for what comes in-between-actual compliance with these requirements. Senior leadership must make this clear throughout the organization.

[c] Who is the Compliance Officer?

Organizations should have a compliance officer who can command attention throughout the organization and must give that compliance officer direct and regular access to senior management and the board of directors. As the SEC has explained, the compliance or ethics officer identified in an organization's code of conduct must have "sufficient status in the company to engender respect for the code and the authority to deal with persons subject to the code regardless of their status in the company."² The Ad Hoc Advisory Group believes that "the official charged with implementing an organization's compliance program [must have] the formal authority, access to senior management, and the respect needed to manage and oversee" the program, while the Sentencing Commission has called for such individual(s) to "be given adequate resources, appropriate authority, and direct access to the governing authority, or an appropriate subgroup of the governing authority."³ Likewise, an analysis by five ethics and compliance organizations has concluded that "an executive position of Chief Ethics and Compliance Officer (CECO) with broad authority, access to the Chief Executive and the Board, and sufficient financial and other resources is a central element in the successful development of an ethical culture in organizations."⁴

Compliance officers these days typically report directly to the CEO or to some other high-level executive such as the General Counsel. Some also have a "dotted line" or even a direct line to the Audit Committee of the Board of Directors, reflecting their ability to report directly to the board in the event of serious compliance violations or allegations of misconduct by senior executives. In these cases, according to the Ad Hoc Advisory Group, compliance officers must be able to report to the organization's governing authority "without the potential filtering or censoring influence of senior organization managers." The study by the ethics organizations concludes that "the decision as to where the CECO will report is perhaps the single biggest influence on the credibility and authority of the role." As a consequence, the CECO should report in at least some fashion to the "top of the organization"--meaning the CEO and/or the Board.⁵

The DOJ, in its testimony to the Ad Hoc Advisory Group, put the issue this way:

We believe it is critical that compliance officers have a direct reporting line to the CEO, the Board of Directors, the outside auditors, or some independent committee of the Board. This access is critical,

we believe, to uncovering and preventing criminal activity by high ranking corporate managers.n6

As noted above, health care companies must consider the views of the OIG that the CCO should not report to the General Counsel or the Chief Financial Officer.

In the aftermath of the Enron bankruptcy, the National Association of Corporate Directors recommended that boards "review the adequacy of their companies' compliance and reporting systems at least annually. In particular, boards should ensure that management pays strict attention to ethical behavior and compliance with laws and regulations, approved auditing and accounting principles, and with internal governing documents."n7 It should finally be noted in this regard that, as the "profession" of compliance officer has developed, various organizations have begun to create Standards of Conduct for the job and even to devise certification training and tests, much as other professions have been doing for years.n8

[d] What are the Resources for Compliance?

The compliance officer must also have the commitment of resources to effectively implement the code of conduct, regardless of where he or she sits on the organization chart. The Thompson Memorandum notes that one way the DOJ will evaluate compliance in an organization is to look "whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts."n9 The Ad Hoc Advisory Group adds that "the allocation of these sorts of resources is needed to ensure that a company's compliance program is not just a paper program, but rather a substantial management effort with the resources needed to succeed."n10

Senior management and boards of directors must ask themselves the kinds of questions about their compliance programs that regulators, prosecutors and employees will ask: have they provided the people and other resources--either within the compliance department or from other departments within the organization--to:

- conduct compliance training and otherwise communicate compliance standards and expectations; to analyze and respond to hotline calls;
- regularly track and evaluate new laws and regulations; to monitor and audit business unit compliance performance;
- report to directors and senior management on compliance performance; and
- respond firmly and effectively to issues, problems and violations.

These resources need not all be within a centralized compliance function. A growing number of organizations--especially those with large numbers of employees and locations around the world--have adopted a "hybrid" approach in which the corporate compliance staff is augmented by business resources "on-the-ground" in various business units and international markets. The localized resources can be full-time or part-time. They offer colleagues accessible, business-knowledgeable assistance and can be linked to the organizational compliance objectives through their compliance with standards set up the corporate compliance leaders, periodic reporting to headquarters and participation on a company-wide compliance committee.

[e] How is Senior Leadership Involved with the Compliance Program?

Many organizations have established internal compliance and ethics committees to help organize, strengthen and promote compliance efforts even after the code has been drafted and implemented. These committees may include senior-level representatives of internal audit, law, human resources, information technology, corporate security and line business units, in addition to compliance officers. Some even include the CEO and other leaders at the highest-levels of

the organization. These committees communicate the organization's commitment to compliance and the importance to the most senior executives of the practical, business application of ethics and integrity.

Besides sending the message about the importance of compliance, these compliance leadership teams may also:

- identify and track the organization's response to new legal and regulatory requirements;
- oversee the company's compliance risk assessment and match compliance resources and actions to those risks;
- develop and oversee the implementation of an annual compliance plan;
- set standards for compliance activities in the business units;
- develop tools for communicating, training, monitoring and reporting about compliance; and
- ensure the application of appropriate compliance controls to new business initiatives.

In order to exercise this leadership and oversight, senior executives must receive--and be obligated to react to--regular reports on the compliance performance of the organization. At one company, for example, a quarterly compliance report is made to all members of its Management Committee and then to the Audit Committee of its Board of Directors. This quarterly report has three parts: a written summary of the key compliance issues and activities for that quarter, including any compliance audits or investigations and the primary focus of the compliance team for the period; a report on compliance training throughout the company; and a summary of all the possible violations reported including the nature of the matter, how and when it was reported, by whom it was investigated, and the resolution.

[f] Enterprise Risk Management

One trend that has accelerated in recent years is to consider the compliance function as part of a consolidated Enterprise Risk Management (ERM) team. Under this approach, compliance is combined with Internal Audit, the Sarbanes-Oxley oversight staff and often a "strategic risk management" team under the leadership of a senior executive, more typically as part of finance rather than legal. The ERM approach accomplishes at least three objectives for organizational compliance. First, it gives the compliance team ready access to the internal audit resources and business process oversight needed to accomplish compliance objectives. Second, it places the compliance program squarely in the context of the organization's overall approach to risk, thus making more obvious the contributions that compliance is making to business objectives. Third, this ERM process is most often driven by the organization's CEO and Board.

Here is how one organization has coordinated compliance and ERM. The company conducts an annual assessment of enterprise risks including compliance, financial, business and strategic risks. This assessment reflects the insights of the risk management team, but its analysis is vetted by senior business leaders. The outcome is the identification of the most significant risks and the assignment of responsibility for addressing those risks to risk management, compliance, internal audit or business leaders, as appropriate. Thus, for example, the compliance team may be assigned one or more of the highest priority risks such as compliance with data privacy regulations or oversight of foreign business practices in "corruption-prone" areas. The annual compliance plan is informed by this process, and business leaders throughout the organization can see the direct link between their issues and concerns and the efforts of the compliance team.

This organization ensures coordination by having the chief compliance officer serve on its Enterprise Risk Management Committee, and by adding an ERM representative to its Compliance Committee. The importance of compliance and risk management to broader organizational goals is demonstrated by the inclusion of these issues in the yearly bonus calculations for senior business leaders and their managers.

[3] Communications and Training

The adoption of a new or revised code of conduct should be a significant event, one that is accompanied by a comprehensive communications and training program to emphasize the importance and value of the code, and raise its profile, within the organization. To drive the right behaviors throughout the business and workforce, an organization needs a comprehensive communications plan that makes compliance come alive. This plan should have three parts: (1) raising awareness about the importance of compliance issues; (2) engaging leaders and employees at all levels of the organization in conversations about compliance and ethics through meetings, town halls, focus groups and one-on-ones; and (3) driving behavior--using the results of these interactions to make the compliance program and tools more relevant and effective.

The awareness campaign can begin with the distribution of the code of conduct to all identified stakeholders in hard copy and electronically, in addition to the public disclosures mandated by the regulators, and this distribution can be accompanied by a wide variety of internal communications and compliance-related events to raise awareness and interest.

Organizations may distribute monthly compliance bulletins, newsletters, regular e-mails or special reports on the code and any new regulations or recent enforcement actions. Some have created in-house compliance videos or instituted compliance awards ceremonies to recognize employees and business units for their compliance performance and commitment. Others have special pens, note pads or other items with a compliance-related theme or slogan, or they may have posters, payroll inserts, wallet cards or telephone stickers with the compliance hotline number. Organizations may also have compliance sites on their internal websites for employees to read the code and related policies and procedures, access other resources, take on-line training courses and even ask questions.

Companies are increasingly providing annual training to all employees and others who are covered by their codes, and are also providing introductory compliance training to new employees. Organizational training plans often include both in-person training and on-line training with the subject matter falling into two categories: general compliance awareness and code of conduct training on the one hand, and training about more specific compliance risks related to particular jobs, on the other. This compliance communications and training program cannot be static and, if at all possible, it should not stay at headquarters. As cost-effective as on-line training can be, there is no substitute for live, in-person training at those business units and geographic areas where compliance risks are highest and the likelihood of mistakes or misunderstandings the greatest. Employees of a new joint venture in China or India, for example, can take an on-line training course about the U.S. Foreign Corrupt Practices Act, but only a personal visit from a compliance leader or other resource can make them fully appreciate the scope of the Act, its application to their jobs, the enormous individual and institutional risks, and the myriad ways they can be exposed to those risks.

Moreover, compliance training cannot be "once and done"--a one-time event that accompanies the launch of a new code or the settlement of a compliance matter, and then does not occur again until the next investigation. Compliance training must be part of the regular rhythms and activities of the organization. One best practice is for each business unit and geographic market to develop an annual compliance training plan reflecting the nature of the business and the applicable regulatory issues.

Organizations operating outside the United States need to consider translating the code and compliance training into other languages, and whether some of the provisions and examples in the code need to be modified to reflect local practices, issues and concerns. These organizations also need to provide access to any reporting mechanisms, such as hotlines, for employees and others outside the United States, consistent with the EU data privacy and labor law issues discussed earlier in this chapter.

Employment discrimination cases have held that a code of conduct alone, without communications and training, will not protect an employer from punitive damages. Instead, an employer can avoid such liability if it had implemented "a

well-publicized policy forbidding sexual harassment, gave training on sexual harassment to new employees, established a grievance procedure for sexual harassment complaints, and initiated an investigation of the plaintiffs' complaints."n11

[4] Monitoring and Auditing

It has been said that organizations manage what they measure. If compliance with the code of conduct is important to an organization, then the roll-out of the code should be accompanied by a comprehensive plan to measure and monitor the compliance performance of the business units and individuals subject to the code. This can include regular reporting of compliance performance indicators as well as periodic audits of particular issues, conducted by internal audit or compliance staff.

In this regard, organizations need to determine what these performance indicators will be and how they can be identified, measured and reported. To be most effective, these efforts should be consistent with how the business is managed in general. There should be two categories of indicators, one for the compliance staff and one for the business. This will reinforce the essential point that compliance is every business unit's--and every individual's--responsibility, not just the job of the compliance team.

The first set of indicators reflects the activities of the *compliance* department and staff such as: the number and types of training programs conducted; any communications released to staff; the number and results of compliance-related audits; the number, type and outcomes of calls to the compliance hotline; any regulatory examinations, investigations, audits or inquiries that were handled by compliance; and any Compliance related customer complaints.

The other category of indicators reflects the compliance-related performance of *business* units. These indicators will generally be industry-specific. In health-maintenance organizations, for example, they could include reports on the timeliness of claims processing, the handling of requests for service, and the licensing of sales staff. In financial services, compliance performance indicators could include measures of sales practices such as replacements of existing policies, suitability of sales, agent disciplinary actions, investigations or inquiries by regulators, agent and client retention, timeliness and frequency of customer transactions, monitoring of employee stock trades and field audit results. Each business unit should create a compliance plan that incorporates these key indicators, required remediation from internal audits, and other commitments to regulators and external stakeholders.

The key is to relate the indicators to the most important regulations impacting the organizations. Both categories of compliance performance indicators should be reported regularly to senior business management and to the board of directors.

The compliance program guidance from the OIG puts it this way:

An ongoing evaluation process is critical to a successful compliance program ... Compliance reports created by this ongoing monitoring, including reports of suspected noncompliance should be maintained by the compliance officer and shared with senior management.n12

The OIG adds that "one effective tool to promote and ensure compliance is the performance of regular, periodic compliance audits by internal or external auditors who have expertise in Federal and State health care program requirements."

The DII describes compliance audits as "systematic reviews of the policies, procedures, and practices at specific operations or divisions, and regular examinations of selected activities to ensure compliance. They serve to verify the existence and the efficacy of the company's internal procedures; to assess adherence to the company's code of conduct and compliance with federal procurement laws; to monitor risks; and to develop corrective action programs."n13

Regardless of the compliance performance indicators or monitoring and auditing techniques that are used, organizations must have a structured means of responding to identified issues and documenting these responses. Some organizations have developed special tracking reports--or use existing management and performance reports--to ensure that identified compliance-related deficiencies are eliminated.

[5] Logging, Investigating and Reporting

It also is imperative, in this intense regulatory and enforcement environment, for organizations to implement effective processes for investigating all of the compliance-related matters that are reported through the various tools we have described earlier. This enables companies to prevent problems in the first instance, keep small issues from becoming big problems, identify trends or other potential company-wide concerns and--in each instance--investigate and effectively address compliance concerns without outside intervention. One company has created the Compliance Incident and Investigations Protocol to achieve these objectives. First, the Protocol requires that business leaders and supervisors across the organization make prompt reports to the Compliance Team of all *possible* violations of the code of conduct or other compliance-related rules and policies. Second, the Protocol provides a single interface for the handling of all compliance issues, as the Compliance Team logs each report from any source into a centralized case management system. Third, business leaders, other interested parties (such as human resources where appropriate) and the Compliance Team then agree on the need for investigation, the process and resources for conducting investigations and the response to each matter. Finally, the Protocol is used to generate monthly reports to company leaders and quarterly reports to the Audit Committee of the Board of Directors. In this way, the organization has simplified compliance investigations and reports, involved the right people quickly and effectively, and achieved better outcomes for the organization and for the individuals involved in these matters.¹⁴

[6] Annual Compliance Plan

Organizations should have annual compliance plans, just as they have annual business plans. According to one regulator, the way to measure an organization's "culture of compliance" is to determine if it has provided the resources and leadership to:

- (1) develop a "strategic vision" for compliance that fits in with corporate goals;
- (2) identify specific compliance risks related to this vision;
- (3) establish control points for each risk;
- (4) manage and document the process of controlling each risk; and
- (5) make specific people accountable for managing each element of the compliance program.¹⁵

Central to this process is the development of a compliance plan and program that reflects the regulations applicable to the business of the organization, industry practices and issues, the size and structure of the organization and its compliance history. "Off-the-shelf" compliance programs will not be effective.

The level of effort and resources committed to the compliance planning process is a tangible reflection of the priority attached to the program by the leadership of the organization, and it will help determine whether the compliance staff has the ability to know what is going on throughout the business and can effectively influence organizational and individual behavior.

[7] Review and Modification

The compliance program must also have a built-in process for reviewing and modifying the code, and the other elements of the program, in response to changes in business conditions, new laws and regulations or problems that have been identified. Some companies do a structured "yearly review" of their compliance program. During this process, they review recent regulatory developments in their industry, examine the results of compliance audits and other performance indicators and determine if additional compliance resources, training, audits or other actions are needed in particular business units or with regard to specified subjects.

Former SEC Chairman William Donaldson, in discussing the Commission's requirement that all investment advisers have compliance programs, has said that:

The adequacy and effectiveness of these [compliance] policies and procedures must be reviewed at least once a year. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures.¹⁶

Other organizations have a formal process for identifying, communicating and tracking compliance with the laws and regulations. These organizations designate business and legal "issue owners" for the various categories of laws and regulations that apply to the business, and then assure that appropriate processes and resources are in place to identify and address changes in laws and regulations in these areas. This has the added advantage of helping integrate and embed compliance issues and concerns into business units throughout the organization. Another approach to this process is for the compliance and legal staffs to identify and evaluate each new law and regulation, send a description to each business unit that might be impacted and require the business units to explain how they will comply. The compliance department will then periodically check with the business units to determine if they are in full compliance. This allows the organization to adjust its compliance program based on any new regulatory mandates that are identified and to track and document its efforts. Another useful technique is to formally include compliance as an express part of each new business initiative. As one SEC official stated:

One of the most important lessons we have learned is that your compliance program cannot be static. It can't be 'done,' 'on the shelf,' or 'fixed.' An effective compliance program must continue to evolve and, to do so, the program must be able to identify, meet and incorporate changes in your business.¹⁷

Each of these ideas needs to be considered--and, if appropriate, built into the compliance program--before the code of conduct is adopted and communicated, so that the organization is ready to make the code succeed.

[8] Employee Surveys of the Company's Compliance Culture

In addition to using the compliance performance measures described above, some organizations are using employee surveys to assess employee attitudes about the compliance culture and program. These surveys can measure employee attitudes about the "tone at the top," awareness about the compliance program elements, willingness to ask for help and raise issues without fear of retaliation, and perceptions about their managers' commitment to doing the right thing. According to Patricia Harned, President of the Ethics Resource Center, "[a] critical element on the effectiveness of a program has to be: 'What do our employees think?'"¹⁸ Organizations that are willing to test and address these attitudes on the front lines will be better able to create, promote, maintain and demonstrate the kind of culture of ethics and compliance that is now being demanded by regulators, prosecutors and compliance experts.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations General Overview Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview

FOOTNOTES:

(n1)Footnote 1. Corporate Governance Handbook 2007: Legal Standards and Board Practices, pare 92, The Conference Board 2007.

(n2)Footnote 2. See SEC Release Nos. 33-8138; 34-46701; IC-25775 (Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002) at 146, n.67 (Oct. 16, 2002).

(n3)Footnote 3. See Ad Hoc Advisory Group Report at 62; Amendments to the Sentencing Guidelines, Policy Statements, and Official Commentary (May 1, 2004), available at www.ussc.gov/2004guid/2004cong.pdf.

(n4)Footnote 4. See, "Leading Corporate Integrity: Defining the Role of Chief Ethics and Compliance Officer (CECO), 2007, published by the Ethics Resource Center and available at www.ethics.org/CECO.

(n5)Footnote 5. *Id.* At 20.

(n6)Footnote 6. See Testimony of the United States Department of Justice Before the Ad Hoc Advisory Group (Nov. 14, 2002) at 15, available at www.ussc.gov. See also, Restoring Trust, Report to the Hon. Jed S. Rakoff. The United States District Court for the Southern District of New York, on Corporate Governance for the Future of MCI, Inc. (Aug. 2003) at 18, n.9 ("While establishing such an [ethics] office is a good step, it does not become significant until the program is adequately staffed and has senior leadership with direct access to the board and the EO.").

(n7)Footnote 7. Recommendations from the National Association of Corporate Directors, Submitted March 1, 2002, Updated May 1, 2002, contained in the Report of the New York Exchange Corporate Accountability and Listing Standards Committee (CALs) (June 6, 2002) at A-90.

(n8)Footnote 8. See, e.g., "The Standards of Conduct: Business Ethics and Compliance Professionals," of the Ethics and Compliance Officer Association, www.theecoa.org; and the Certified Compliance and Ethics Professional (CCEP) of the Society for Corporate Compliance and Ethics, www.corporatecompliance.org.

(n9)Footnote 9. See Thompson Memorandum at § VII.

(n10)Footnote 10. Ad Hoc Advisory Group Report at 62.

(n11)Footnote 11. See *Hatley v. Hilton Hotels Corp.*, 308 F.3d 473, 477 (5th Cir. 2002) .

(n12)Footnote 12. See OIG Compliance Program Guidance for Medicare+Choice Organizations Offering Coordinated Care Plans, 64 Fed. Reg. 61896, 61906 (Nov. 15, 1999) .

(n13)Footnote 13. DII 2006 Annual Report at 47, available at www.dii.org.

(n14)Footnote 14. The process of investigating violations of the code of conduct is not without its perils, as witnessed by the controversy involving Hewlett-Packard. In that case, the company's former Board chairwoman *and its former senior counsel and director of ethics* were charged by California state authorities with several crimes, in connection with their investigation into possible leaks of confidential company information by members of the Board of Directors. The charges stemmed from the use by outside investigators working for the company of a technique called "pretexting" to obtain the home-phone and cell-phone records of targets of the investigation. While no convictions resulted, the investigation extracted an enormous personal and professional toll on the organization and the individuals involved. One lesson here is to engage the services of very experienced outside counsel to help plan, oversee and even conduct compliance investigations of any magnitude.

(n15)Footnote 15. See speech by Lori A. Richards, The Culture of Compliance (Apr. 23, 2003), available at www.sec.gov.

(n16)Footnote 16. Speech by SEC Chairman: Remarks Before the Investment Counsel Association of America (Apr. 22, 2004), *available at* www.sec.gov.

(n17)Footnote 17. Speech by Lori Richards, Remarks Before the Investment Advisor Compliance Best Practices Summit: Compliance Programs: Our Shared Mission, at 2 (Feb. 28, 2005), *available at* www.sec.org.

(n18)Footnote 18. *See* Harned, P., *Beyond the Code: Benchmarking Ethics and Compliance Programs*, Compliance Week, Monthly Special Print Edition (Aug. 2005).



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.12

AUTHOR: Jay M. Cohen

§ 13.12 Four Substantive Principles to Guide the Compliance Program

Here are four substantive principles to keep in mind in drafting and revising the code of conduct, and in reviewing and enhancing the organization's compliance program.

- (1) Good business equals good compliance. Business processes and tools-and relevant, understandable policies and procedures-that improve the effectiveness of business operations will also promote compliance and integrity.
- (2) There should be no gap between the size and complexity of the business and the scope of its code of conduct and overall compliance program. Compliance policies, controls and tools must reflect the specifics of-and changes in-the business, and must be built into and alongside new business initiatives and technologies.
- (3) Companies' compliance endeavors will be held to standards of "best practices" and compared to what other companies are doing in their own compliance programs. As we have seen throughout this chapter, regulators are becoming more sophisticated and demanding about what good compliance programs and cultures should look like, and they will judge companies' compliance programs according to increasingly high standards.
- (4) Keep in mind the two goals of organizational compliance: to prevent, detect and respond appropriately and aggressively to any violations of laws, regulations and company policies; and to limit organizational responsibility for the inevitable violations by individuals, because of everything the company did to meet the first goal before those violations occurred.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning

Documents & ProceduresGeneral Overview



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CHAPTER 13 COMPLIANCE AND THE CODE OF CONDUCT

2-13 Corporate Governance: Law and Practice § 13.13

AUTHOR: Jay M. Cohen

§ 13.13 Conclusion: The Importance of the Code of Conduct

Codes of conduct--and accompanying compliance and ethics programs--do make a difference, as judged by the actions of employees, government agencies and companies. According to the 2007 National Business Ethics Survey of more than 3,000 American workers, conducted by the Ethics Resource Center ("ERC"), employees are more likely to report misconduct--and less likely to feel pressure to compromise standards of business conduct--when their organization has both an "ethical culture" and compliance or ethics program including written standards of conduct.ⁿ¹

As the corporate monitor appointed by the federal court in the WorldCom case stated: "[A]n important part of the structure of any company should be the adoption and communication of a statement of values and principles ... A code of ethics is an opportunity for a company to express important values, and in this manner reflect both the norms of society generally, and the standards of behavior that the company wishes to set for itself."ⁿ²

Even when the latest round of corporate scandals fades from memory, compliance with legal and regulatory requirements and ethical standards will remain a constant responsibility of every organization. Each organization's compliance program should begin with--and be built around--a strong, comprehensive code of conduct.

Legal Topics:

For related research and practice materials, see the following legal topics:
 Business & Corporate LawCorporationsGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral Overview

FOOTNOTES:

(n1)Footnote 1. *See* 2005 National Business Ethics Survey (NBES), *available at* www.ethics.org. Other surveys have found similar results. *See, for example,* KPMG Forensic, Integrity Survey 2005-2006, *available at* www.us.kpmg.com. A 2005 Benchmarking Study by the Open Compliance and Ethics Group identified another benefit to upfront investments in compliance--companies that have experienced reputational damage from regulatory problems have had to spend three times more for their compliance programs than their "non-damaged peers." This study is *available at*

www.oceg.org.

(n2)Footnote 2. *See* Breeden, R. C., Restoring Trust, Report to the Hon. Jed S. Rakoff on Corporate Governance for the Future of MCI, Inc. (Aug. 2003) at 138.



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Appendix 13-A The Federal Sentencing Guidelines for Organizations (As amended, effective Nov. 1, 2004)

2-13-A Corporate Governance: Law and Practice Appendix 13-A.syn

§ 13-A.syn Synopsis to Appendix 13-A: The Federal Sentencing Guidelines for Organizations (As amended, effective Nov. 1, 2004)

[13-A] The Federal Sentencing Guidelines for Organizations (As amended, effective Nov. 1, 2004)



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Appendix 13-A The Federal Sentencing Guidelines for Organizations (As amended, effective Nov. 1, 2004)

2-13-A Corporate Governance: Law and Practice [13-A]

[13-A] The Federal Sentencing Guidelines for Organizations (As amended, effective Nov. 1, 2004)

CHAPTER EIGHT - SENTENCING OF ORGANIZATIONS

Introductory Commentary

The guidelines and policy statements in this chapter apply when the convicted defendant is an organization. Organizations can act only through agents and, under federal criminal law, generally are vicariously liable for offenses committed by their agents. At the same time, individual agents are responsible for their own criminal conduct. Federal prosecutions of organizations therefore frequently involve individual and organizational co-defendants. Convicted individual agents of organizations are sentenced in accordance with the guidelines and policy statements in the preceding chapters. This chapter is designed so that the sanctions imposed upon organizations and their agents, taken together, will provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct.

This chapter reflects the following general principles:

First, the court must, whenever practicable, order the organization to remedy any harm caused by the offense. The resources expended to remedy the harm should not be viewed as punishment, but rather as a means of making victims whole for the harm caused.

Second, if the organization operated primarily for a criminal purpose or primarily by criminal means, the fine should be set sufficiently high to divest the organization of all its assets.

Third, the fine range for any other organization should be based on the seriousness of the offense and the culpability of the organization. The seriousness of the offense generally will be reflected by the greatest of the pecuniary gain, the pecuniary loss, or the amount in a guideline offense level fine table. Culpability generally will be determined by six factors that the sentencing court must consider. The four factors that increase the ultimate punishment of an organization are: (i) the involvement in or tolerance of criminal activity; (ii) the prior history of the organization; (iii) the violation of an order; and (iv) the obstruction of justice. The two factors that mitigate the ultimate punishment of an organization are: (i) the existence of an effective compliance and ethics program; and (ii) self-reporting, cooperation, or acceptance of responsibility.

Fourth, probation is an appropriate sentence for an organizational defendant when needed to ensure that another sanction will be fully implemented, or to ensure that steps will be taken within the organization to reduce the likelihood of future criminal conduct.

These guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in complying fully with all applicable laws.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

PART A - GENERAL APPLICATION PRINCIPLES

§ 8A1.1. Applicability of Chapter Eight

This chapter applies to the sentencing of all organizations for felony and Class A misdemeanor offenses.

Commentary

Application Notes:

1. "Organization" means "a person other than an individual." 18 U.S.C. § 18. The term includes corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and political subdivisions thereof, and non-profit organizations.

2. The fine guidelines in §§ 8C2.2 through 8C2.9 apply only to specified types of offenses. The other provisions of this chapter apply to the sentencing of all organizations for all felony and Class A misdemeanor offenses. For example, the restitution and probation provisions in Parts B and D of this chapter apply to the sentencing of an organization, even if the fine guidelines in §§ 8C2.2 through 8C2.9 do not apply.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8A1.2. Application Instructions - Organizations

(a) Determine from Part B, Subpart 1 (Remedying Harm from Criminal Conduct) the sentencing requirements and options relating to restitution, remedial orders, community service, and notice to victims.

(b) Determine from Part C (Fines) the sentencing requirements and options relating to fines:

(1) If the organization operated primarily for a criminal purpose or primarily by criminal means, apply § 8C1.1 (Determining the Fine - Criminal Purpose Organizations).

(2) Otherwise, apply § 8C2.1 (Applicability of Fine Guidelines) to identify the counts for which the provisions of §§ 8C2.2 through 8C2.9 apply. For such counts:

(A) Refer to § 8C2.2 (Preliminary Determination of Inability to Pay Fine) to determine whether an abbreviated determination of the guideline fine range may be warranted.

(B) Apply § 8C2.3 (Offense Level) to determine the offense level from Chapter Two (Offense Conduct) and Chapter Three, Part D (Multiple Counts).

(C) Apply § 8C2.4 (Base Fine) to determine the base fine.

(D) Apply § 8C2.5 (Culpability Score) to determine the culpability score. To determine whether the organization had an effective compliance and ethics program for purposes of § 8C2.5(f), apply § 8B2.1 (Effective Compliance and Ethics Program).

(E) Apply § 8C2.6 (Minimum and Maximum Multipliers) to determine the minimum and maximum multipliers corresponding to the culpability score.

(F) Apply § 8C2.7 (Guideline Fine Range - Organizations) to determine the minimum and maximum of the guideline fine range.

(G) Refer to § 8C2.8 (Determining the Fine Within the Range) to determine the amount of the fine within the applicable guideline range.

(H) Apply § 8C2.9 (Disgorgement) to determine whether an increase to the fine is required.

For any count or counts not covered under § 8C2.1 (Applicability of Fine Guidelines), apply § 8C2.10 (Determining the Fine for Other Counts).

(3) Apply the provisions relating to the implementation of the sentence of a fine in Part C, Subpart 3 (Implementing the Sentence of a Fine).

(4) For grounds for departure from the applicable guideline fine range, refer to Part C, Subpart 4 (Departures from the Guideline Fine Range).

(c) Determine from Part D (Organizational Probation) the sentencing requirements and options relating to probation.

(d) Determine from Part E (Special Assessments, Forfeitures, and Costs) the sentencing requirements relating to special assessments, forfeitures, and costs.

Commentary

Application Notes:

1. Determinations under this chapter are to be based upon the facts and information specified in the applicable guideline. Determinations that reference other chapters are to be made under the standards applicable to determinations under those chapters.

2. The definitions in the Commentary to § 1B1.1 (Application Instructions) and the guidelines and commentary in §§ 1B1.2 through 1B1.8 apply to determinations under this chapter unless otherwise specified. The adjustments in Chapter Three, Parts A (Victim-Related Adjustments), B (Role in the Offense), C (Obstruction), and E (Acceptance of Responsibility) do not apply. The provisions of Chapter Six (Sentencing Procedures and Plea Agreements) apply to proceedings in which the defendant is an organization. Guidelines and policy statements not referenced in this chapter, directly or indirectly, do

not apply when the defendant is an organization; e.g., the policy statements in Chapter Seven (Violations of Probation and Supervised Release) do not apply to organizations.

3. *The following are definitions of terms used frequently in this chapter:*

(a) "Offense" means the offense of conviction and all relevant conduct under § 1B1.3 (Relevant Conduct) unless a different meaning is specified or is otherwise clear from the context. The term "instant" is used in connection with "offense," "federal offense," or "offense of conviction," as the case may be, to distinguish the violation for which the defendant is being sentenced from a prior or subsequent offense, or from an offense before another court (e.g., an offense before a state court involving the same underlying conduct).

(b) "High-level personnel of the organization" means individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization. The term includes: a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest. "High-level personnel of a unit of the organization" is defined in the Commentary to § 8C2.5 (Culpability Score).

(c) "Substantial authority personnel" means individuals who within the scope of their authority exercise a substantial measure of discretion in acting on behalf of an organization. The term includes high-level personnel of the organization, individuals who exercise substantial supervisory authority (e.g., a plant manager, a sales manager), and any other individuals who, although not a part of an organization's management, nevertheless exercise substantial discretion when acting within the scope of their authority (e.g., an individual with authority in an organization to negotiate or set price levels or an individual authorized to negotiate or approve significant contracts). Whether an individual falls within this category must be determined on a case-by-case basis.

(d) "Agent" means any individual, including a director, an officer, an employee, or an independent contractor, authorized to act on behalf of the organization.

(e) An individual "condoned" an offense if the individual knew of the offense and did not take reasonable steps to prevent or terminate the offense.

(f) "Similar misconduct" means prior conduct that is similar in nature to the conduct underlying the instant offense, without regard to whether or not such conduct violated the same statutory provision. For example, prior Medicare fraud would be misconduct similar to an instant offense involving another type of fraud.

(g) "Prior criminal adjudication" means conviction by trial, plea of guilty (including an Alford plea), or plea of nolo contendere.

(h) "Pecuniary gain" is derived from 18 U.S.C. § 3571(d) and means the additional before-tax profit to the defendant resulting from the relevant conduct of the offense. Gain can result from either additional revenue or cost savings. For example, an offense involving odometer tampering can produce additional revenue. In such a case, the pecuniary gain is the additional revenue received because the automobiles appeared to

have less mileage, i.e., the difference between the price received or expected for the automobiles with the apparent mileage and the fair market value of the automobiles with the actual mileage. An offense involving defense procurement fraud related to defective product testing can produce pecuniary gain resulting from cost savings. In such a case, the pecuniary gain is the amount saved because the product was not tested in the required manner.

(i) "Pecuniary loss" is derived from 18 U.S.C. § 3571(d) and is equivalent to the term "loss" as used in Chapter Two (Offense Conduct). See Commentary to § 2B1.1 (Theft, Property Destruction, and Fraud), and definitions of "tax loss" in Chapter Two, Part T (Offenses Involving Taxation).

(j) An individual was "willfully ignorant of the offense" if the individual did not investigate the possible occurrence of unlawful conduct despite knowledge of circumstances that would lead a reasonable person to investigate whether unlawful conduct had occurred.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422); November 1, 1997 (see Appendix C, amendment 546); November 1, 2001 (see Appendix C, amendment 617); November 1, 2004 (see Appendix C, amendment 673).

PART B - REMEDYING HARM FROM CRIMINAL CONDUCT, AND EFFECTIVE COMPLIANCE AND ETHICS PROGRAM

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

1. REMEDYING HARM FROM CRIMINAL CONDUCT

Historical Note: Effective November 1, 2004 (see Appendix C, amendment 673).

Introductory Commentary

As a general principle, the court should require that the organization take all appropriate steps to provide compensation to victims and otherwise remedy the harm caused or threatened by the offense. A restitution order or an order of probation requiring restitution can be used to compensate identifiable victims of the offense. A remedial order or an order of probation requiring community service can be used to reduce or eliminate the harm threatened, or to repair the harm caused by the offense, when that harm or threatened harm would otherwise not be remedied. An order of notice to victims can be used to notify unidentified victims of the offense.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8B1.1. Restitution - Organizations

(a) In the case of an identifiable victim, the court shall --

(1) enter a restitution order for the full amount of the victim's loss, if such order is authorized under 18 U.S.C. § 2248, § 2259, § 2264, § 2327, § 3663, or § 3663A; or

(2) impose a term of probation or supervised release with a condition requiring restitution for the full amount of the victim's loss, if the offense is not an offense for which restitution is authorized under 18 U.S.C. § 3663(a)(1) but otherwise meets the criteria for an order of restitution under that section.

(b) Provided, that the provisions of subsection (a) do not apply --

(1) when full restitution has been made; or

(2) in the case of a restitution order under § 3663; a restitution order under *18 U.S.C. § 3663A* that pertains to an offense against property described in *18 U.S.C. § 3663A(c)(1)(A)(ii)*; or a condition of restitution imposed pursuant to subsection (a)(2) above, to the extent the court finds, from facts on the record, that (A) the number of identifiable victims is so large as to make restitution impracticable; or (B) determining complex issues of fact related to the cause or amount of the victim's losses would complicate or prolong the sentencing process to a degree that the need to provide restitution to any victim is outweighed by the burden on the sentencing process.

(c) If a defendant is ordered to make restitution to an identifiable victim and to pay a fine, the court shall order that any money paid by the defendant shall first be applied to satisfy the order of restitution.

(d) A restitution order may direct the defendant to make a single, lump sum payment, partial payments at specified intervals, in-kind payments, or a combination of payments at specified intervals and in-kind payments. See *18 U.S.C. § 3664(f)(3)(A)*. An in-kind payment may be in the form of (1) return of property; (2) replacement of property; or (3) if the victim agrees, services rendered to the victim or to a person or organization other than the victim. See *18 U.S.C. § 3664(f)(4)*.

(e) A restitution order may direct the defendant to make nominal periodic payments if the court finds from facts on the record that the economic circumstances of the defendant do not allow the payment of any amount of a restitution order, and do not allow for the payment of the full amount of a restitution order in the foreseeable future under any reasonable schedule of payments.

(f) Special Instruction

(1) This guideline applies only to a defendant convicted of an offense committed on or after November 1, 1997. Notwithstanding the provisions of § 1B1.11 (Use of Guidelines Manual in Effect on Date of Sentencing), use the former § 8B1.1 (set forth in Appendix C, amendment 571) in lieu of this guideline in any other case.

Commentary

Background: Section 3553(a)(7) of Title 18, United States Code, requires the court, "in determining the particular sentence to be imposed," to consider "the need to provide restitution to any victims of the offense." Orders of restitution are authorized under 18 U.S.C. §§ 2248, 2259, 2264, 2327, 3663, and 3663A. For offenses for which an order of restitution is not authorized, restitution may be imposed as a condition of probation.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422); November 1, 1997 (see Appendix C, amendment 571).

§ 8B1.2. Remedial Orders - Organizations (Policy Statement)

(a) To the extent not addressed under § 8B1.1 (Restitution - Organizations), a remedial order imposed as a condition of probation may require the organization to remedy the harm caused by the offense and to eliminate or reduce the risk that the instant offense will cause future harm.

(b) If the magnitude of expected future harm can be reasonably estimated, the court may require the organization to create a trust fund sufficient to address that expected harm.

Commentary

Background: The purposes of a remedial order are to remedy harm that has already occurred and to prevent future harm. A remedial order requiring corrective action by the organization may be necessary to prevent future injury from the instant offense, e.g., a product recall for a food and drug violation or a clean-up order for an environmental violation. In some cases in which a remedial order potentially may be appropriate, a governmental regulatory agency, e.g., the Environmental Protection Agency or the Food and Drug Administration, may have authority to order remedial measures. In such cases, a remedial order by the court may not be necessary. If a remedial order is entered, it should be coordinated with any administrative or civil actions taken by the appropriate governmental regulatory agency.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8B1.3. Community Service - Organizations (Policy Statement)

Community service may be ordered as a condition of probation where such community service is reasonably designed to repair the harm caused by the offense.

Commentary

Background: An organization can perform community service only by employing its resources or paying its employees or others to do so. Consequently, an order that an organization perform community service is essentially an indirect monetary sanction, and therefore generally less desirable than a direct monetary sanction. However, where the convicted organization possesses knowledge, facilities, or skills that uniquely qualify it to repair damage caused by the offense, community service directed at repairing damage may provide an efficient means of remedying harm caused.

In the past, some forms of community service imposed on organizations have not been related to the purposes of sentencing. Requiring a defendant to endow a chair at a university or to contribute to a local charity would not be consistent with this section unless such community service provided a means for preventive or corrective action directly related to the offense and therefore served one of the purposes of sentencing set forth in 18 U.S.C. § 3553(a).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8B1.4. Order of Notice to Victims - Organizations

Apply § 5F1.4 (Order of Notice to Victims).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

2. EFFECTIVE COMPLIANCE AND ETHICS PROGRAM

Historical Note: Effective November 1, 2004 (see Appendix C, amendment 673).

§ 8B2.1. Effective Compliance and Ethics Program

(a) To have an effective compliance and ethics program, for purposes of subsection (f) of § 8C2.5 (Culpability Score) and subsection (c)(1) of § 8D1.4 (Recommended Conditions of Probation - Organizations), an organization shall--

(1) exercise due diligence to prevent and detect criminal conduct; and

(2) otherwise promote an organizational culture that encourages ethical conduct and a

commitment to compliance with the law.

Such compliance and ethics program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct. The failure to prevent or detect the instant offense does not necessarily mean that the program is not generally effective in preventing and detecting criminal conduct.

(b) Due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law within the meaning of subsection (a) minimally require the following:

(1) The organization shall establish standards and procedures to prevent and detect criminal conduct.

(2)

(A) The organization's governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.

(B) High-level personnel of the organization shall ensure that the organization has an effective compliance and ethics program, as described in this guideline. Specific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program.

(C) Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.

(3) The organization shall use reasonable efforts not to include within the substantial authority personnel of the organization any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program.

(4)

(A) The organization shall take reasonable steps to communicate periodically and in a practical manner its standards and procedures, and other aspects of the compliance and ethics program, to the individuals referred to in subdivision (B) by conducting effective training programs and otherwise disseminating information appropriate to such individuals' respective roles and responsibilities.

(B) The individuals referred to in subdivision (A) are the members of the governing authority, high-level personnel, substantial authority personnel, the organization's employees, and, as appropriate, the organization's agents.

(5) The organization shall take reasonable steps --

(A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;

(B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and

(C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

(6) The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.

(7) After criminal conduct has been detected, the organization shall take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program.

(c) In implementing subsection (b), the organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process.

Commentary

Application Notes:

1. *Definitions.--For purposes of this guideline:*

"Compliance and ethics program" means a program designed to prevent and detect criminal conduct.

"Governing authority" means the (A) the Board of Directors; or (B) if the organization does not have a Board of Directors, the highest-level governing body of the organization.

"High-level personnel of the organization" and "substantial authority personnel" have the meaning given those terms in the Commentary to § 8A1.2 (Application Instructions - Organizations).

"Standards and procedures" means standards of conduct and internal controls that are reasonably capable of reducing the likelihood of criminal conduct.

2. *Factors to Consider in Meeting Requirements of this Guideline.--*

(A) In General.--Each of the requirements set forth in this guideline shall be met by an organization; however, in determining what specific actions are necessary to meet those requirements, factors that shall be considered include: (i) applicable industry practice or the standards called for by any applicable governmental regulation; (ii) the size of the

organization; and (iii) similar misconduct.

(B) Applicable Governmental Regulation and Industry Practice.--An organization's failure to incorporate and follow applicable industry practice or the standards called for by any applicable governmental regulation weighs against a finding of an effective compliance and ethics program.

(C) The Size of the Organization.--

(i) In General.--The formality and scope of actions that an organization shall take to meet the requirements of this guideline, including the necessary features of the organization's standards and procedures, depend on the size of the organization.

(ii) Large Organizations.--A large organization generally shall devote more formal operations and greater resources in meeting the requirements of this guideline than shall a small organization. As appropriate, a large organization should encourage small organizations (especially those that have, or seek to have, a business relationship with the large organization) to implement effective compliance and ethics programs.

(iii) Small Organizations.--In meeting the requirements of this guideline, small organizations shall demonstrate the same degree of commitment to ethical conduct and compliance with the law as large organizations. However, a small organization may meet the requirements of this guideline with less formality and fewer resources than would be expected of large organizations. In appropriate circumstances, reliance on existing resources and simple systems can demonstrate a degree of commitment that, for a large organization, would only be demonstrated through more formally planned and implemented systems.

Examples of

the informality and use of fewer resources with which a small organization may meet the requirements of this guideline include the following: (I) the governing authority's discharge of its responsibility for oversight of the compliance and ethics program by directly managing the organization's compliance and ethics efforts; (II) training employees through informal staff meetings, and monitoring through regular "walk-arounds" or continuous observation while managing the organization; (III) using available personnel, rather than employing separate staff, to carry out the compliance and ethics program; and (IV) modeling its own compliance and ethics program on existing, well-regarded compliance and ethics programs and best practices of other similar organizations.

(D) Recurrence of Similar Misconduct. --Recurrence of similar misconduct creates doubt regarding whether the organization took reasonable steps to meet the requirements of this guideline. For purposes of this subdivision, "similar misconduct" has the meaning given that term in the Commentary to § 8A1.2 (Application Instructions - Organizations).

3. Application of Subsection (b)(2).--High-level personnel and substantial authority personnel of the organization shall be knowledgeable about the content and operation of the compliance and ethics program, shall perform their assigned duties consistent with the exercise of due diligence, and shall promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

If the specific individual(s) assigned overall responsibility for the compliance and ethics program does not have day-to-day operational responsibility for the program, then the individual(s) with

day-to-day operational responsibility for the program typically should, no less than annually, give the governing authority or an appropriate subgroup thereof information on the implementation and effectiveness of the compliance and ethics program.

4. *Application of Subsection (b)(3). --*

(A) Consistency with Other Law. --Nothing in subsection (b)(3) is intended to require conduct inconsistent with any Federal, State, or local law, including any law governing employment or hiring practices.

(B) Implementation. --In implementing subsection (b)(3), the organization shall hire and promote individuals so as to ensure that all individuals within the high-level personnel and substantial authority personnel of the organization will perform their assigned duties in a manner consistent with the exercise of due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law under subsection (a). With respect to the hiring or promotion of such individuals, an organization shall consider the relatedness of the individual's illegal activities and other misconduct (i.e., other conduct inconsistent with an effective compliance and ethics program) to the specific responsibilities the individual is anticipated to be assigned and other factors such as: (i) the recency of the individual's illegal activities and other misconduct; and (ii) whether the individual has engaged in other such illegal activities and other such misconduct.

5. *Application of Subsection (b)(6).--Adequate discipline of individuals responsible for an offense is a necessary component of enforcement; however, the form of discipline that will be appropriate will be case specific.*

6. *Application of Subsection (c). --To meet the requirements of subsection (c), an organization shall:*

(A) Assess periodically the risk that criminal conduct will occur, including assessing the following:

(i) The nature and seriousness of such criminal conduct.

(ii) The likelihood that certain criminal conduct may occur because of the nature of the organization's business. If, because of the nature of an organization's business, there is a substantial risk that certain types of criminal conduct may occur, the organization shall take reasonable steps to prevent and detect that type of criminal conduct. For example, an organization that, due to the nature of its business, employs sales personnel who have flexibility to set prices shall establish standards and procedures designed to prevent and detect price-fixing. An organization that, due to the nature of its business, employs sales personnel who have flexibility to represent the material characteristics of a product shall establish standards and procedures designed to prevent and detect fraud.

(iii) The prior history of the organization. The prior history of an organization may indicate types of criminal conduct that it shall take actions to prevent and detect.

(B) Prioritize periodically, as appropriate, the actions taken pursuant to any requirement set forth in subsection (b), in order to focus on preventing and detecting the criminal conduct identified under subdivision (A) of this note as most serious, and most likely, to occur.

(C) Modify, as appropriate, the actions taken pursuant to any requirement set forth in subsection (b) to reduce the risk of criminal conduct identified under subdivision (A) of this note as most serious, and most likely, to occur.

Background: This section sets forth the requirements for an effective compliance and ethics program. This section responds to section 805(a)(2)(5) of the Sarbanes-Oxley Act of 2002, Public Law 107--204, which directed the Commission to review and amend, as appropriate, the guidelines and related policy statements to ensure that the guidelines that apply to organizations in this chapter "are sufficient to deter and punish organizational criminal misconduct."

The requirements set forth in this guideline are intended to achieve reasonable prevention and detection of criminal conduct for which the organization would be vicariously liable. The prior diligence of an organization in seeking to prevent and detect criminal conduct has a direct bearing on the appropriate penalties and probation terms for the organization if it is convicted and sentenced for a criminal offense.

Historical Note: Effective November 1, 2004 (see Appendix C, amendment 673).

PART C - FINES

1. DETERMINING THE FINE - CRIMINAL PURPOSE ORGANIZATIONS

§ 8C1.1. Determining the Fine - Criminal Purpose Organizations

If, upon consideration of the nature and circumstances of the offense and the history and characteristics of the organization, the court determines that the organization operated primarily for a criminal purpose or primarily by criminal means, the fine shall be set at an amount (subject to the statutory maximum) sufficient to divest the organization of all its net assets. When this section applies, Subpart 2 (Determining the Fine - Other Organizations) and § 8C3.4 (Fines Paid by Owners of Closely Held Organizations) do not apply.

Commentary

Application Note:

1. "Net assets," as used in this section, means the assets remaining after payment of all legitimate claims against assets by known innocent bona fide creditors.

Background: This guideline addresses the case in which the court, based upon an examination of the nature and circumstances of the offense and the history and characteristics of the organization, determines that the organization was operated primarily for a criminal purpose (e.g., a front for a scheme that was designed to commit fraud; an organization established to participate in the illegal manufacture, importation, or distribution of a controlled substance) or operated primarily by criminal means (e.g., a hazardous waste disposal business that had no legitimate means of disposing of hazardous waste). In such a case, the fine shall be set at an amount sufficient to remove all of the organization's net assets. If the extent of the assets of the organization is unknown, the maximum fine authorized by statute should be imposed, absent innocent bona fide creditors.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

* * *

2. DETERMINING THE FINE - OTHER ORGANIZATIONS

§ 8C2.1. Applicability of Fine Guidelines

The provisions of §§ 8C2.2 through 8C2.9 apply to each count for which the applicable guideline offense level is

determined under:

(a) §§ 2B1.1, 2B1.4, 2B2.3, 2B4.1, 2B5.3, 2B6.1;

§ § 2C1.1, 2C1.2, 2C1.6, 2C1.7;

§ § 2D1.7, 2D3.1, 2D3.2;

§ § 2E3.1, 2E4.1, 2E5.1, 2E5.3;

§ 2G3.1;

§ § 2K1.1, 2K2.1;

§ 2L1.1;

§ 2N3.1;

§ 2R1.1;

§ § 2S1.1, 2S1.3;

§ § 2T1.1, 2T1.4, 2T1.6, 2T1.7, 2T1.8, 2T1.9, 2T2.1, 2T2.2, 2T3.1; or

(b) §§ 2E1.1, 2X1.1, 2X2.1, 2X3.1, 2X4.1, with respect to cases in which the offense level for the underlying offense is determined under one of the guideline sections listed in subsection (a) above.

Commentary

Application Notes:

1. If the Chapter Two offense guideline for a count is listed in subsection (a) or (b) above, and the applicable guideline results in the determination of the offense level by use of one of the listed guidelines, apply the provisions of §§ 8C2.2 through 8C2.9 to that count. For example, §§ 8C2.2 through 8C2.9 apply to an offense under § 2K2.1 (an offense guideline listed in subsection (a)), unless the cross reference in that guideline requires the offense level to be determined under an offense guideline section not listed in subsection (a).

2. If the Chapter Two offense guideline for a count is not listed in subsection (a) or (b) above, but the applicable guideline results in the determination of the offense level by use of a listed guideline, apply the provisions of §§ 8C2.2 through 8C2.9 to that count. For example, where the conduct set forth in a count of conviction ordinarily referenced to § 2N2.1 (an offense guideline not listed in subsection (a)) establishes § 2B1.1 (Theft, Property Destruction, and Fraud) as the applicable offense guideline (an offense guideline listed in subsection (a)), §§ 8C2.2 through 8C2.9 would apply because the actual offense level is determined under § 2B1.1 (Theft, Property Destruction, and Fraud).

Background: The fine guidelines of this subpart apply only to offenses covered by the guideline sections set forth in subsection (a) above. For example, the provisions of §§ 8C2.2 through 8C2.9 do not apply to counts for which the applicable guideline offense level is determined under Chapter Two, Part Q (Offenses Involving the Environment). For

such cases, § 8C2.10 (*Determining the Fine for Other Counts*) is applicable.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 1992 (see Appendix C, amendment 453); November 1, 1993 (see Appendix C, amendment 496); November 1, 2001 (see Appendix C, amendments 617, 619, and 634).

§ 8C2.2. Preliminary Determination of Inability to Pay Fine

(a) Where it is readily ascertainable that the organization cannot and is not likely to become able (even on an installment schedule) to pay restitution required under § 8B1.1 (Restitution - Organizations), a determination of the guideline fine range is unnecessary because, pursuant to § 8C3.3(a), no fine would be imposed.

(b) Where it is readily ascertainable through a preliminary determination of the minimum of the guideline fine range (see §§ 8C2.3 through 8C2.7) that the organization cannot and is not likely to become able (even on an installment schedule) to pay such minimum guideline fine, a further determination of the guideline fine range is unnecessary. Instead, the court may use the preliminary determination and impose the fine that would result from the application of § 8C3.3 (Reduction of Fine Based on Inability to Pay).

Commentary

Application Notes:

1. *In a case of a determination under subsection (a), a statement that "the guideline fine range was not determined because it is readily ascertainable that the defendant cannot and is not likely to become able to pay restitution" is recommended.*

2. *In a case of a determination under subsection (b), a statement that "no precise determination of the guideline fine range is required because it is readily ascertainable that the defendant cannot and is not likely to become able to pay the minimum of the guideline fine range" is recommended.*

Background: Many organizational defendants lack the ability to pay restitution. In addition, many organizational defendants who may be able to pay restitution lack the ability to pay the minimum fine called for by § 8C2.7(a). In such cases, a complete determination of the guideline fine range may be a needless exercise. This section provides for an abbreviated determination of the guideline fine range that can be applied where it is readily ascertainable that the fine within the guideline fine range determined under § 8C2.7 (Guideline Fine Range - Organizations) would be reduced under § 8C3.3 (Reduction of Fine Based on Inability to Pay).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C2.3. Offense Level

(a) For each count covered by § 8C2.1 (Applicability of Fine Guidelines), use the applicable Chapter Two guideline to determine the base offense level and apply, in the order listed, any appropriate adjustments contained in that guideline.

(b) Where there is more than one such count, apply Chapter Three, Part D (Multiple Counts) to determine the combined offense level.

Commentary

Application Notes:

1. In determining the offense level under this section, "defendant," as used in Chapter Two, includes any agent of the organization for whose conduct the organization is criminally responsible.

2. In determining the offense level under this section, apply the provisions of §§ 1B1.2 through 1B1.8. Do not apply the adjustments in Chapter Three, Parts A (Victim-Related Adjustments), B (Role in the Offense), C (Obstruction), and E (Acceptance of Responsibility).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C2.4. Base Fine

(a) The base fine is the greatest of:

(1) the amount from the table in subsection (d) below corresponding to the offense level determined under § 8C2.3 (Offense Level); or

(2) the pecuniary gain to the organization from the offense; or

(3) the pecuniary loss from the offense caused by the organization, to the extent the loss was caused intentionally, knowingly, or recklessly.

(b) Provided, that if the applicable offense guideline in Chapter Two includes a special instruction for organizational fines, that special instruction shall be applied, as appropriate.

(c) Provided, further, that to the extent the calculation of either pecuniary gain or pecuniary loss would unduly complicate or prolong the sentencing process, that amount, i.e., gain or loss as appropriate, shall not be used for the determination of the base fine.

(d) Offense Level Fine Table

Offense Level	Amount
6 or less	\$5,000
7	\$7,500
8	\$10,000
9	\$15,000
10	\$20,000
11	\$30,000
12	\$40,000
13	\$60,000
14	\$85,000
15	\$125,000
16	\$175,000
17	\$250,000
18	\$350,000
19	\$500,000

20	\$650,000
21	\$910,000
22	\$1,200,000
23	\$1,600,000
24	\$2,100,000
25	\$2,800,000
26	\$3,700,000
27	\$4,800,000
28	\$6,300,000
29	\$8,100,000
30	\$10,500,000
31	\$13,500,000
32	\$17,500,000
33	\$22,000,000
34	\$28,500,000
35	\$36,000,000
36	\$45,500,000
37	\$57,500,000
38 or more	\$72,500,000.

Commentary

Application Notes:

1. "Pecuniary gain," "pecuniary loss," and "offense" are defined in the Commentary to § 8A1.2 (Application Instructions - Organizations). Note that subsections (a)(2) and (a)(3) contain certain limitations as to the use of pecuniary gain and pecuniary loss in determining the base fine. Under subsection (a)(2), the pecuniary gain used to determine the base fine is the pecuniary gain to the organization from the offense. Under subsection (a)(3), the pecuniary loss used to determine the base fine is the pecuniary loss from the offense caused by the organization, to the extent that such loss was caused intentionally, knowingly, or recklessly.

2. Under 18 U.S.C. § 3571(d), the court is not required to calculate pecuniary loss or pecuniary gain to the extent that determination of loss or gain would unduly complicate or prolong the sentencing process. Nevertheless, the court may need to approximate loss in order to calculate offense levels under Chapter Two. See Commentary to § 2B1.1 (Theft, Property Destruction, and Fraud). If loss is approximated for purposes of determining the applicable offense level, the court should use that approximation as the starting point for calculating pecuniary loss under this section.

3. In a case of an attempted offense or a conspiracy to commit an offense, pecuniary loss and pecuniary gain are to be determined in accordance with the principles stated in § 2X1.1 (Attempt, Solicitation, or Conspiracy).

4. In a case involving multiple participants (i.e., multiple organizations, or the organization and individual(s) unassociated with the organization), the applicable offense level is to be determined without regard to apportionment of the gain from or loss caused by the offense. See § 1B1.3 (Relevant Conduct). However, if the base fine is determined under subsections (a)(2) or (a)(3), the court may, as appropriate, apportion gain or loss considering the defendant's relative culpability and other pertinent factors. Note also that under § 2R1.1(d)(1), the volume of commerce, which is used in determining a proxy for loss under § 8C2.4(a)(3), is limited to the volume of commerce attributable to the defendant.

5. Special instructions regarding the determination of the base fine are contained in §§ 2B4.1 (Bribery in Procurement of Bank Loan and Other Commercial Bribery); 2C1.1 (Offering, Giving, Soliciting, or Receiving a Bribe; Extortion Under Color of Official Right; Fraud Involving the Deprivation of the Intangible Right to Honest Services of Public Officials; Conspiracy to Defraud by Interference with Governmental Functions); 2C1.2 (Offering, Giving, Soliciting, or Receiving a Gratuity); 2E5.1 (Offering, Accepting, or Soliciting a Bribe or Gratuity Affecting the Operation of an Employee Welfare or Pension Benefit Plan; Prohibited Payments or Lending of Money by Employer or Agent to Employees, Representatives, or Labor Organizations); and 2R1.1 (Bid-Rigging, Price-Fixing or Market-Allocation Agreements Among Competitors).

Background: Under this section, the base fine is determined in one of three ways: (1) by the amount, based on the offense level, from the table in subsection (d); (2) by the pecuniary gain to the organization from the offense; and (3) by the pecuniary loss caused by the organization, to the extent that such loss was caused intentionally, knowingly, or recklessly. In certain cases, special instructions for determining the loss or offense level amount apply. As a general rule, the base fine measures the seriousness of the offense. The determinants of the base fine are selected so that, in conjunction with the multipliers derived from the culpability score in § 8C2.5 (Culpability Score), they will result in guideline fine ranges appropriate to deter organizational criminal conduct and to provide incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct. In order to deter organizations from seeking to obtain financial reward through criminal conduct, this section provides that, when greatest, pecuniary gain to the organization is used to determine the base fine. In order to ensure that organizations will seek to prevent losses intentionally, knowingly, or recklessly caused by their agents, this section provides that, when greatest, pecuniary loss is used to determine the base fine in such circumstances. Chapter Two provides special instructions for fines that include specific rules for determining the base fine in connection with certain types of offenses in which the calculation of loss or gain is difficult, e.g., price-fixing. For these offenses, the special instructions tailor the base fine to circumstances that occur in connection with such offenses and that generally relate to the magnitude of loss or gain resulting from such offenses.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 1993 (see Appendix C, amendment 496); November 1, 1995 (see Appendix C, amendment 534); November 1, 2001 (see Appendix C, amendment 634); November 1, 2004 (see Appendix C, amendments 666 and 673).

§ 8C2.5. Culpability Score

(a) Start with 5 points and apply subsections (b) through (g) below.

(b) Involvement in or Tolerance of Criminal Activity

If more than one applies, use the greatest:

(1) If --

(A) the organization had 5,000 or more employees and

(i) an individual within high-level personnel of the organization participated in, condoned, or was willfully ignorant of the offense; or

(ii) tolerance of the offense by substantial authority personnel was pervasive throughout the organization; or

(B) the unit of the organization within which the offense was committed had 5,000 or more employees and

(i) an individual within high-level personnel of the unit participated in, condoned, or was willfully ignorant of the offense; or

(ii) tolerance of the offense by substantial authority personnel was pervasive throughout such unit,

add **5** points; or

(2) If --

(A) the organization had 1,000 or more employees and

(i) an individual within high-level personnel of the organization participated in, condoned, or was willfully ignorant of the offense; or

(ii) tolerance of the offense by substantial authority personnel was pervasive throughout the organization; or

(B) the unit of the organization within which the offense was committed had 1,000 or more employees and

(i) an individual within high-level personnel of the unit participated in, condoned, or was willfully ignorant of the offense; or

(ii) tolerance of the offense by substantial authority personnel was pervasive throughout such unit,

add **4** points; or

(3) If --

(A) the organization had 200 or more employees and

(i) an individual within high-level personnel of the organization participated in, condoned, or was willfully ignorant of the offense; or

(ii) tolerance of the offense by substantial authority personnel was pervasive throughout the organization; or

(B) the unit of the organization within which the offense was committed had 200 or more employees and

(i) an individual within high-level personnel of the unit participated in, condoned, or

was willfully ignorant of the offense; or

(ii) tolerance of the offense by substantial authority personnel was pervasive throughout such unit,

add **3** points; or

(4) If the organization had 50 or more employees and an individual within substantial authority personnel participated in, condoned, or was willfully ignorant of the offense, add **2** points; or

(5) If the organization had 10 or more employees and an individual within substantial authority personnel participated in, condoned, or was willfully ignorant of the offense, add **1** point.

(c) Prior History

If more than one applies, use the greater:

(1) If the organization (or separately managed line of business) committed any part of the instant offense less than 10 years after (A) a criminal adjudication based on similar misconduct; or (B) civil or administrative adjudication(s) based on two or more separate instances of similar misconduct, add **1** point; or

(2) If the organization (or separately managed line of business) committed any part of the instant offense less than 5 years after (A) a criminal adjudication based on similar misconduct; or (B) civil or administrative adjudication(s) based on two or more separate instances of similar misconduct, add **2** points.

(d) Violation of an Order

If more than one applies, use the greater:

(1) (A) If the commission of the instant offense violated a judicial order or injunction, other than a violation of a condition of probation; or (B) if the organization (or separately managed line of business) violated a condition of probation by engaging in similar misconduct, i.e., misconduct similar to that for which it was placed on probation, add **2** points; or

(2) If the commission of the instant offense violated a condition of probation, add **1** point.

(e) Obstruction of Justice

If the organization willfully obstructed or impeded, attempted to obstruct or impede, or aided, abetted, or encouraged obstruction of justice during the investigation, prosecution, or sentencing of the instant offense, or, with knowledge thereof, failed to take reasonable steps to prevent such obstruction or impedance or attempted obstruction or impedance, add **3** points.

(f) Effective Compliance and Ethics Program

(1) If the offense occurred even though the organization had in place at the time of the offense an effective compliance and ethics program, as provided in § 8B2.1 (Effective Compliance and Ethics Program), subtract **3** points.

(2) Subsection (f)(1) shall not apply if, after becoming aware of an offense, the organization unreasonably delayed reporting the offense to appropriate governmental authorities.

(3)

(A) Except as provided in subdivision (B), subsection (f)(1) shall not apply if an individual within high-level personnel of the organization, a person within high-level personnel of the unit of the organization within which the offense was committed where the unit had 200 or more employees, or an individual described in § 8B2.1(b)(2)(B) or (C), participated in, condoned, or was willfully ignorant of the offense.

(B) There is a rebuttable presumption, for purposes of subsection (f)(1), that the organization did not have an effective compliance and ethics program if an individual--

(i) within high-level personnel of a small organization; or

(ii) within substantial authority personnel, but not within high-level personnel, of any organization, participated in, condoned, or was willfully ignorant of, the offense.

(g) Self-Reporting, Cooperation, and Acceptance of Responsibility

If more than one applies, use the greatest:

(1) If the organization (A) prior to an imminent threat of disclosure or government investigation; and (B) within a reasonably prompt time after becoming aware of the offense, reported the offense to appropriate governmental authorities, fully cooperated in the investigation, and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract **5** points; or

(2) If the organization fully cooperated in the investigation and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract **2** points; or

(3) If the organization clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract **1** point.

Commentary

Application Notes:

1. *Definitions.--For purposes of this guideline, "condoned", "prior criminal adjudication", "similar misconduct", "substantial authority personnel", and "willfully ignorant of the offense" have the meaning given those terms in Application Note 3 of the Commentary to § 8A1.2 (Application Instructions - Organizations).*

"Small Organization", for purposes of subsection (f)(3), means an organization that, at the time of the instant offense, had fewer than 200 employees.

2. *For purposes of subsection (b), "unit of the organization" means any reasonably distinct operational component of the organization. For example, a large organization may have several large units such as*

divisions or subsidiaries, as well as many smaller units such as specialized manufacturing, marketing, or accounting operations within these larger units. For purposes of this definition, all of these types of units are encompassed within the term "unit of the organization."

3. "High-level personnel of the organization" is defined in the Commentary to § 8A1.2 (Application Instructions - Organizations). With respect to a unit with 200 or more employees, "high-level personnel of a unit of the organization" means agents within the unit who set the policy for or control that unit. For example, if the managing agent of a unit with 200 employees participated in an offense, three points would be added under subsection (b)(3); if that organization had 1,000 employees and the managing agent of the unit with 200 employees were also within high-level personnel of the organization in its entirety, four points (rather than three) would be added under subsection (b)(2).

4. Pervasiveness under subsection (b) will be case specific and depend on the number, and degree of responsibility, of individuals within substantial authority personnel who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an organization. For example, if an offense were committed in an organization with 1,000 employees but the tolerance of the offense was pervasive only within a unit of the organization with 200 employees (and no high-level personnel of the organization participated in, condoned, or was willfully ignorant of the offense), three points would be added under subsection (b)(3). If, in the same organization, tolerance of the offense was pervasive throughout the organization as a whole, or an individual within high-level personnel of the organization participated in the offense, four points (rather than three) would be added under subsection (b)(2).

5. A "separately managed line of business," as used in subsections (c) and (d), is a subpart of a for-profit organization that has its own management, has a high degree of autonomy from higher managerial authority, and maintains its own separate books of account. Corporate subsidiaries and divisions frequently are separately managed lines of business. Under subsection (c), in determining the prior history of an organization with separately managed lines of business, only the prior conduct or criminal record of the separately managed line of business involved in the instant offense is to be used. Under subsection (d), in the context of an organization with separately managed lines of business, in making the determination whether a violation of a condition of probation involved engaging in similar misconduct, only the prior misconduct of the separately managed line of business involved in the instant offense is to be considered.

6. Under subsection (c), in determining the prior history of an organization or separately managed line of business, the conduct of the underlying economic entity shall be considered without regard to its legal structure or ownership. For example, if two companies merged and became separate divisions and separately managed lines of business within the merged company, each division would retain the prior history of its predecessor company. If a company reorganized and became a new legal entity, the new company would retain the prior history of the predecessor company. In contrast, if one company purchased the physical assets but not the ongoing business of another company, the prior history of the company selling the physical assets would not be transferred to the company purchasing the assets. However, if an organization is acquired by another organization in response to solicitations by appropriate federal government officials, the prior history of the acquired organization shall not be attributed to the acquiring organization.

7. Under subsections (c)(1)(B) and (c)(2)(B), the civil or administrative adjudication(s) must have occurred within the specified period (ten or five years) of the instant offense.

8. *Adjust the culpability score for the factors listed in subsection (e) whether or not the offense guideline incorporates that factor, or that factor is inherent in the offense.*

9. *Subsection (e) applies where the obstruction is committed on behalf of the organization; it does not apply where an individual or individuals have attempted to conceal their misconduct from the organization. The Commentary to § 3C1.1 (Obstructing or Impeding the Administration of Justice) provides guidance regarding the types of conduct that constitute obstruction.*

10. *Subsection (f)(2) contemplates that the organization will be allowed a reasonable period of time to conduct an internal investigation. In addition, no reporting is required by subsection (f)(2) if the organization reasonably concluded, based on the information then available, that no offense had been committed.*

11. *"Appropriate governmental authorities," as used in subsections (f) and (g)(1), means the federal or state law enforcement, regulatory, or program officials having jurisdiction over such matter. To qualify for a reduction under subsection (g)(1), the report to appropriate governmental authorities must be made under the direction of the organization.*

12. *To qualify for a reduction under subsection (g)(1) or (g)(2), cooperation must be both timely and thorough. To be timely, the cooperation must begin essentially at the same time as the organization is officially notified of a criminal investigation. To be thorough, the cooperation should include the disclosure of all pertinent information known by the organization. A prime test of whether the organization has disclosed all pertinent information is whether the information is sufficient for law enforcement personnel to identify the nature and extent of the offense and the individual(s) responsible for the criminal conduct. However, the cooperation to be measured is the cooperation of the organization itself, not the cooperation of individuals within the organization. If, because of the lack of cooperation of particular individual(s), neither the organization nor law enforcement personnel are able to identify the culpable individual(s) within the organization despite the organization's efforts to cooperate fully, the organization may still be given credit for full cooperation. Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.*

13. *Entry of a plea of guilty prior to the commencement of trial combined with truthful admission of involvement in the offense and related conduct ordinarily will constitute significant evidence of affirmative acceptance of responsibility under subsection (g), unless outweighed by conduct of the organization that is inconsistent with such acceptance of responsibility. This adjustment is not intended to apply to an organization that puts the government to its burden of proof at trial by denying the essential factual elements of guilt, is convicted, and only then admits guilt and expresses remorse. Conviction by trial, however, does not automatically preclude an organization from consideration for such a reduction. In rare situations, an organization may clearly demonstrate an acceptance of responsibility for its criminal conduct even though it exercises its constitutional right to a trial. This may occur, for example, where an organization goes to trial to assert and preserve issues that do not relate to factual guilt (e.g., to make a constitutional challenge to a statute or a challenge to the applicability of a statute to its conduct). In each such instance, however, a determination that an organization has accepted responsibility will be based primarily upon pretrial statements and conduct.*

14. *In making a determination with respect to subsection (g), the court may determine that the chief executive officer or highest ranking employee of an organization should appear at sentencing in order to signify that the organization has clearly demonstrated recognition and affirmative acceptance of*

responsibility.

Background: The increased culpability scores under subsection (b) are based on three interrelated principles. First, an organization is more culpable when individuals who manage the organization or who have substantial discretion in acting for the organization participate in, condone, or are willfully ignorant of criminal conduct. Second, as organizations become larger and their managements become more professional, participation in, condonation of, or willful ignorance of criminal conduct by such management is increasingly a breach of trust or abuse of position. Third, as organizations increase in size, the risk of criminal conduct beyond that reflected in the instant offense also increases whenever management's tolerance of that offense is pervasive. Because of the continuum of sizes of organizations and professionalization of management, subsection (b) gradually increases the culpability score based upon the size of the organization and the level and extent of the substantial authority personnel involvement.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

§ 8C2.6. Minimum and Maximum Multipliers

Using the culpability score from § 8C2.5 (Culpability Score) and applying any applicable special instruction for fines in Chapter Two, determine the applicable minimum and maximum fine multipliers from the table below.

Culpability Score	Minimum Multiplier	Maximum Multiplier
10 or more	2.00	4.00
9	1.80	3.60
8	1.60	3.20
7	1.40	2.80
6	1.20	2.40
5	1.00	2.00
4	0.80	1.60
3	0.60	1.20
2	0.40	0.80
1	0.20	0.40
0 or less	0.05	0.20.

Commentary

Application Note:

1. A special instruction for fines in § 2R1.1 (Bid-Rigging, Price-Fixing or Market-Allocation Agreements Among Competitors) sets a floor for minimum and maximum multipliers in cases covered by that guideline.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C2.7. Guideline Fine Range - Organizations

(a) The minimum of the guideline fine range is determined by multiplying the base fine determined under § 8C2.4 (Base Fine) by the applicable minimum multiplier determined

under § 8C2.6 (Minimum and Maximum Multipliers).

(b) The maximum of the guideline fine range is determined by multiplying the base fine determined under § 8C2.4 (Base Fine) by the applicable maximum multiplier determined under § 8C2.6 (Minimum and Maximum Multipliers).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C2.8. Determining the Fine Within the Range (Policy Statement)

(a) In determining the amount of the fine within the applicable guideline range, the court should consider:

(1) the need for the sentence to reflect the seriousness of the offense, promote respect for the law, provide just punishment, afford adequate deterrence, and protect the public from further crimes of the organization;

(2) the organization's role in the offense;

(3) any collateral consequences of conviction, including civil obligations arising from the organization's conduct;

(4) any nonpecuniary loss caused or threatened by the offense;

(5) whether the offense involved a vulnerable victim;

(6) any prior criminal record of an individual within high-level personnel of the organization or high-level personnel of a unit of the organization who participated in, condoned, or was willfully ignorant of the criminal conduct;

(7) any prior civil or criminal misconduct by the organization other than that counted under § 8C2.5(c);

(8) any culpability score under § 8C2.5 (Culpability Score) higher than 10 or lower than 0;

(9) partial but incomplete satisfaction of the conditions for one or more of the mitigating or aggravating factors set forth in § 8C2.5 (Culpability Score);

(10) any factor listed in *18 U.S.C. § 3572(a)*; and

(11) whether the organization failed to have, at the time of the instant offense, an effective compliance and ethics program within the meaning of § 8B2.1 (Effective Compliance and Ethics Program).

(b) In addition, the court may consider the relative importance of any factor used to determine the range, including the pecuniary loss caused by the offense, the pecuniary gain from the offense, any specific offense characteristic used to determine the offense level, and any aggravating or mitigating factor used to determine the culpability score.

Commentary**Application Notes:**

1. Subsection (a)(2) provides that the court, in setting the fine within the guideline fine range, should consider the organization's role in the offense. This consideration is particularly appropriate if the guideline fine range does not take the organization's role in the offense into account. For example, the guideline fine range in an antitrust case does not take into consideration whether the organization was an organizer or leader of the conspiracy. A higher fine within the guideline fine range ordinarily will be appropriate for an organization that takes a leading role in such an offense.

2. Subsection (a)(3) provides that the court, in setting the fine within the guideline fine range, should consider any collateral consequences of conviction, including civil obligations arising from the organization's conduct. As a general rule, collateral consequences that merely make victims whole provide no basis for reducing the fine within the guideline range. If criminal and civil sanctions are unlikely to make victims whole, this may provide a basis for a higher fine within the guideline fine range. If punitive collateral sanctions have been or will be imposed on the organization, this may provide a basis for a lower fine within the guideline fine range.

3. Subsection (a)(4) provides that the court, in setting the fine within the guideline fine range, should consider any nonpecuniary loss caused or threatened by the offense. To the extent that nonpecuniary loss caused or threatened (e.g., loss of or threat to human life; psychological injury; threat to national security) by the offense is not adequately considered in setting the guideline fine range, this factor provides a basis for a higher fine within the range. This factor is more likely to be applicable where the guideline fine range is determined by pecuniary loss or gain, rather than by offense level, because the Chapter Two offense levels frequently take actual or threatened nonpecuniary loss into account.

4. Subsection (a)(6) provides that the court, in setting the fine within the guideline fine range, should consider any prior criminal record of an individual within high-level personnel of the organization or within high-level personnel of a unit of the organization. Since an individual within high-level personnel either exercises substantial control over the organization or a unit of the organization or has a substantial role in the making of policy within the organization or a unit of the organization, any prior criminal misconduct of such an individual may be relevant to the determination of the appropriate fine for the organization.

5. Subsection (a)(7) provides that the court, in setting the fine within the guideline fine range, should consider any prior civil or criminal misconduct by the organization other than that counted under § 8C2.5(c). The civil and criminal misconduct counted under § 8C2.5(c) increases the guideline fine range. Civil or criminal misconduct other than that counted under § 8C2.5(c) may provide a basis for a higher fine within the range. In a case involving a pattern of illegality, an upward departure may be warranted.

6. Subsection (a)(8) provides that the court, in setting the fine within the guideline fine range, should consider any culpability score higher than ten or lower than zero. As the culpability score increases above ten, this may provide a basis for a higher fine within the range. Similarly, as the culpability score decreases below zero, this may provide a basis for a lower fine within the range.

7. Under subsection (b), the court, in determining the fine within the range, may consider any factor that it considered in determining the range. This allows for courts to differentiate between cases that have the same offense level but differ in seriousness (e.g., two fraud cases at offense level 12, one resulting in a

loss of \$21,000, the other \$40,000). Similarly, this allows for courts to differentiate between two cases that have the same aggravating factors, but in which those factors vary in their intensity (e.g., two cases with upward adjustments to the culpability score under § 8C2.5(c)(2) (prior criminal adjudications within 5 years of the commencement of the instant offense, one involving a single conviction, the other involving two or more convictions).

Background: Subsection (a) includes factors that the court is required to consider under 18 U.S.C. §§ 3553(a) and 3572(a) as well as additional factors that the Commission has determined may be relevant in a particular case. A number of factors required for consideration under 18 U.S.C. § 3572(a) (e.g., pecuniary loss, the size of the organization) are used under the fine guidelines in this subpart to determine the fine range, and therefore are not specifically set out again in subsection (a) of this guideline. In unusual cases, factors listed in this section may provide a basis for departure.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

§ 8C2.9. Disgorgement

The court shall add to the fine determined under § 8C2.8 (Determining the Fine Within the Range) any gain to the organization from the offense that has not and will not be paid as restitution or by way of other remedial measures.

Commentary

Application Note:

1. This section is designed to ensure that the amount of any gain that has not and will not be taken from the organization for remedial purposes will be added to the fine. This section typically will apply in cases in which the organization has received gain from an offense but restitution or remedial efforts will not be required because the offense did not result in harm to identifiable victims, e.g., money laundering, obscenity, and regulatory reporting offenses. Money spent or to be spent to remedy the adverse effects of the offense, e.g., the cost to retrofit defective products, should be considered as disgorged gain. If the cost of remedial efforts made or to be made by the organization equals or exceeds the gain from the offense, this section will not apply.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C2.10. Determining the Fine for Other Counts

For any count or counts not covered under § 8C2.1 (Applicability of Fine Guidelines), the court should determine an appropriate fine by applying the provisions of 18 U.S.C. §§ 3553 and 3572. The court should determine the appropriate fine amount, if any, to be imposed in addition to any fine determined under § 8C2.8 (Determining the Fine Within the Range) and § 8C2.9 (Disgorgement).

Commentary

Background: The Commission has not promulgated guidelines governing the setting of fines for counts not covered by § 8C2.1 (Applicability of Fine Guidelines). For such counts, the court should determine the appropriate fine based on the general statutory provisions governing sentencing. In cases that have a count or counts not covered by the guidelines in addition to a count or counts covered by the guidelines, the court shall apply the fine guidelines for the count(s) covered by the guidelines, and add any additional amount to the fine, as appropriate, for the count(s) not covered by the guidelines.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

* * *

3. IMPLEMENTING THE SENTENCE OF A FINE

§ 8C3.1. Imposing a Fine

(a) Except to the extent restricted by the maximum fine authorized by statute or any minimum fine required by statute, the fine or fine range shall be that determined under § 8C1.1 (Determining the Fine - Criminal Purpose Organizations); § 8C2.7 (Guideline Fine Range - Organizations) and § 8C2.9 (Disgorgement); or § 8C2.10 (Determining the Fine for Other Counts), as appropriate.

(b) Where the minimum guideline fine is greater than the maximum fine authorized by statute, the maximum fine authorized by statute shall be the guideline fine.

(c) Where the maximum guideline fine is less than a minimum fine required by statute, the minimum fine required by statute shall be the guideline fine.

Commentary

Background: This section sets forth the interaction of the fines or fine ranges determined under this chapter with the maximum fine authorized by statute and any minimum fine required by statute for the count or counts of conviction. The general statutory provisions governing a sentence of a fine are set forth in 18 U.S.C. § 3571.

When the organization is convicted of multiple counts, the maximum fine authorized by statute may increase. For example, in the case of an organization convicted of three felony counts related to a \$200,000 fraud, the maximum fine authorized by statute will be \$500,000 on each count, for an aggregate maximum authorized fine of \$1,500,000.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C3.2. Payment of the Fine - Organizations

(a) If the defendant operated primarily for a criminal purpose or primarily by criminal means, immediate payment of the fine shall be required.

(b) In any other case, immediate payment of the fine shall be required unless the court finds that the organization is financially unable to make immediate payment or that such payment would pose an undue burden on the organization. If the court permits other than immediate payment, it shall require full payment at the earliest possible date, either by requiring payment on a date certain or by establishing an installment schedule.

Commentary

Application Note:

1. When the court permits other than immediate payment, the period provided for payment shall in no event exceed five years. 18 U.S.C. § 3572(d).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C3.3. Reduction of Fine Based on Inability to Pay

(a) The court shall reduce the fine below that otherwise required by § 8C1.1 (Determining the Fine - Criminal Purpose Organizations), or § 8C2.7 (Guideline Fine Range - Organizations) and § 8C2.9 (Disgorgement), to the extent that imposition of such fine would impair its ability to make restitution to victims.

(b) The court may impose a fine below that otherwise required by § 8C2.7 (Guideline Fine Range - Organizations) and § 8C2.9 (Disgorgement) if the court finds that the organization is not able and, even with the use of a reasonable installment schedule, is not likely to become able to pay the minimum fine required by § 8C2.7 (Guideline Fine Range - Organizations) and § 8C2.9 (Disgorgement).

Provided, that the reduction under this subsection shall not be more than necessary to avoid substantially jeopardizing the continued viability of the organization.

Commentary

Application Note:

1. For purposes of this section, an organization is not able to pay the minimum fine if, even with an installment schedule under § 8C3.2 (Payment of the Fine - Organizations), the payment of that fine would substantially jeopardize the continued existence of the organization.

Background: Subsection (a) carries out the requirement in 18 U.S.C. § 3572(b) that the court impose a fine or other monetary penalty only to the extent that such fine or penalty will not impair the ability of the organization to make restitution for the offense; however, this section does not authorize a criminal purpose organization to remain in business in order to pay restitution.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C3.4. Fines Paid by Owners of Closely Held Organizations

The court may offset the fine imposed upon a closely held organization when one or more individuals, each of whom owns at least a 5 percent interest in the organization, has been fined in a federal criminal proceeding for the same offense conduct for which the organization is being sentenced. The amount of such offset shall not exceed the amount resulting from multiplying the total fines imposed on those individuals by those individuals' total percentage interest in the organization.

Commentary

Application Notes:

1. For purposes of this section, an organization is closely held, regardless of its size, when relatively few individuals own it. In order for an organization to be closely held, ownership and management need not completely overlap.

2. This section does not apply to a fine imposed upon an individual that arises out of offense conduct

different from that for which the organization is being sentenced.

Background: For practical purposes, most closely held organizations are the alter egos of their owner-managers. In the case of criminal conduct by a closely held corporation, the organization and the culpable individual(s) both may be convicted. As a general rule in such cases, appropriate punishment may be achieved by offsetting the fine imposed upon the organization by an amount that reflects the percentage ownership interest of the sentenced individuals and the magnitude of the fines imposed upon those individuals. For example, an organization is owned by five individuals, each of whom has a twenty percent interest; three of the individuals are convicted; and the combined fines imposed on those three equals \$100,000. In this example, the fine imposed upon the organization may be offset by up to 60 percent of their combined fine amounts, i.e., by \$60,000.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

* * *

4. DEPARTURES FROM THE GUIDELINE FINE RANGE

Introductory Commentary

The statutory provisions governing departures are set forth in 18 U.S.C. § 3553(b). Departure may be warranted if the court finds "that there exists an aggravating or mitigating circumstance of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission in formulating the guidelines that should result in a sentence different from that described." This subpart sets forth certain factors that, in connection with certain offenses, may not have been adequately taken into consideration by the guidelines. In deciding whether departure is warranted, the court should consider the extent to which that factor is adequately taken into consideration by the guidelines and the relative importance or substantiality of that factor in the particular case.

To the extent that any policy statement from Chapter Five, Part K (Departures) is relevant to the organization, a departure from the applicable guideline fine range may be warranted. Some factors listed in Chapter Five, Part K that are particularly applicable to organizations are listed in this subpart. Other factors listed in Chapter Five, Part K may be applicable in particular cases. While this subpart lists factors that the Commission believes may constitute grounds for departure, the list is not exhaustive.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.1. Substantial Assistance to Authorities - Organizations(Policy Statement)

(a) Upon motion of the government stating that the defendant has provided substantial assistance in the investigation or prosecution of another organization that has committed an offense, or in the investigation or prosecution of an individual not directly affiliated with the defendant who has committed an offense, the court may depart from the guidelines.

(b) The appropriate reduction shall be determined by the court for reasons stated on the record that may include, but are not limited to, consideration of the following:

(1) the court's evaluation of the significance and usefulness of the organization's assistance, taking into consideration the government's evaluation of the assistance rendered;

(2) the nature and extent of the organization's assistance; and

(3) the timeliness of the organization's assistance.

Commentary

Application Note:

1. Departure under this section is intended for cases in which substantial assistance is provided in the investigation or prosecution of crimes committed by individuals not directly affiliated with the organization or by other organizations. It is not intended for assistance in the investigation or prosecution of the agents of the organization responsible for the offense for which the organization is being sentenced.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.2. Risk of Death or Bodily Injury(Policy Statement)

If the offense resulted in death or bodily injury, or involved a foreseeable risk of death or bodily injury, an upward departure may be warranted. The extent of any such departure should depend, among other factors, on the nature of the harm and the extent to which the harm was intended or knowingly risked, and the extent to which such harm or risk is taken into account within the applicable guideline fine range.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.3. Threat to National Security (Policy Statement)

If the offense constituted a threat to national security, an upward departure may be warranted.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.4. Threat to the Environment (Policy Statement)

If the offense presented a threat to the environment, an upward departure may be warranted.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.5. Threat to a Market (Policy Statement)

If the offense presented a risk to the integrity or continued existence of a market, an upward departure may be warranted. This section is applicable to both private markets (e.g., a financial market, a commodities market, or a market for consumer goods) and public markets (e.g., government contracting).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.6. Official Corruption(Policy Statement)

If the organization, in connection with the offense, bribed or unlawfully gave a gratuity to a public official, or attempted or conspired to bribe or unlawfully give a gratuity to a public official, an upward departure may be warranted.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.7. Public Entity (Policy Statement)

If the organization is a public entity, a downward departure may be warranted.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.8. Members or Beneficiaries of the Organization as Victims (Policy Statement)

If the members or beneficiaries, other than shareholders, of the organization are direct victims of the offense, a downward departure may be warranted. If the members or beneficiaries of an organization are direct victims of the offense, imposing a fine upon the organization may increase the burden upon the victims of the offense without achieving a deterrent effect. In such cases, a fine may not be appropriate. For example, departure may be appropriate if a labor union is convicted of embezzlement of pension funds.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.9. Remedial Costs that Greatly Exceed Gain (Policy Statement)

If the organization has paid or has agreed to pay remedial costs arising from the offense that greatly exceed the gain that the organization received from the offense, a downward departure may be warranted. In such a case, a substantial fine may not be necessary in order to achieve adequate punishment and deterrence. In deciding whether departure is appropriate, the court should consider the level and extent of substantial authority personnel involvement in the offense and the degree to which the loss exceeds the gain. If an individual within high-level personnel was involved in the offense, a departure would not be appropriate under this section. The lower the level and the more limited the extent of substantial authority personnel involvement in the offense, and the greater the degree to which remedial costs exceeded or will exceed gain, the less will be the need for a substantial fine to achieve adequate punishment and deterrence.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8C4.10. Mandatory Programs to Prevent and Detect Violations of Law (Policy Statement)

If the organization's culpability score is reduced under § 8C2.5(f) (Effective Compliance and Ethics Program) and the organization had implemented its program in response to a court order or administrative order specifically directed at the organization, an upward departure may be warranted to offset, in part or in whole, such reduction.

Similarly, if, at the time of the instant offense, the organization was required by law to have an effective compliance and ethics program, but the organization did not have such a program, an upward departure may be warranted.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

§ 8C4.11. Exceptional Organizational Culpability (Policy Statement)

If the organization's culpability score is greater than 10, an upward departure may be appropriate.

If no individual within substantial authority personnel participated in, condoned, or was willfully ignorant of the offense; the organization at the time of the offense had an effective program to prevent and detect violations of law; and the base fine is determined under § 8C2.4(a)(1), § 8C2.4(a)(3), or a special instruction for fines in Chapter Two (Offense Conduct), a downward departure may be warranted. In a case meeting these criteria, the court may find that the organization had exceptionally low culpability and therefore a fine based on loss, offense level, or a special Chapter Two instruction results in a guideline fine range higher than necessary to achieve the purposes of sentencing. Nevertheless, such fine should not be lower than if determined under § 8C2.4(a)(2).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

PART D - ORGANIZATIONAL PROBATION***Introductory Commentary***

Section 8D1.1 sets forth the circumstances under which a sentence to a term of probation is required. Sections 8D1.2 through 8D1.4, and 8F1.1, address the length of the probation term, conditions of probation, and violations of probation conditions.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

§ 8D1.1. Imposition of Probation - Organizations

- (a) The court shall order a term of probation:
- (1) if such sentence is necessary to secure payment of restitution (§ 8B1.1), enforce a remedial order (§ 8B1.2), or ensure completion of community service (§ 8B1.3);
 - (2) if the organization is sentenced to pay a monetary penalty (e.g., restitution, fine, or special assessment), the penalty is not paid in full at the time of sentencing, and restrictions are necessary to safeguard the organization's ability to make payments;
 - (3) if, at the time of sentencing, (A) the organization (i) has 50 or more employees, or (ii) was otherwise required under law to have an effective compliance and ethics program; and (B) the organization does not have such a program;
 - (4) if the organization within five years prior to sentencing engaged in similar misconduct, as determined by a prior criminal adjudication, and any part of the misconduct underlying the instant offense occurred after that adjudication;
 - (5) if an individual within high-level personnel of the organization or the unit of the organization within which the instant offense was committed participated in the misconduct underlying the instant offense and that individual within five years prior to sentencing engaged in similar misconduct, as determined by a prior criminal adjudication, and any part of the misconduct underlying the instant offense occurred after that adjudication;
 - (6) if such sentence is necessary to ensure that changes are made within the organization to reduce the likelihood of future criminal conduct;
 - (7) if the sentence imposed upon the organization does not include a fine; or
 - (8) if necessary to accomplish one or more of the purposes of sentencing set forth in 18 U.S.C. § 3553(a)(2).

Commentary

Background: Under 18 U.S.C. § 3561(a), an organization may be sentenced to a term of probation. Under 18 U.S.C. § 3551(c), imposition of a term of probation is required if the sentence imposed upon the organization does not include a fine.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

§ 8D1.2. Term of Probation - Organizations

(a) When a sentence of probation is imposed --

(1) In the case of a felony, the term of probation shall be at least one year but not more than five years.

(2) In any other case, the term of probation shall be not more than five years.

Commentary

Application Note:

1. Within the limits set by the guidelines, the term of probation should be sufficient, but not more than necessary, to accomplish the court's specific objectives in imposing the term of probation. The terms of probation set forth in this section are those provided in 18 U.S.C. § 3561(b).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8D1.3. Conditions of Probation - Organizations

(a) Pursuant to 18 U.S.C. § 3563(a)(1), any sentence of probation shall include the condition that the organization not commit another federal, state, or local crime during the term of probation.

(b) Pursuant to 18 U.S.C. § 3563(a)(2), if a sentence of probation is imposed for a felony, the court shall impose as a condition of probation at least one of the following: (1) restitution, (2) notice to victims of the offense pursuant to 18 U.S.C. § 3555, or (3) an order requiring the organization to reside, or refrain from residing, in a specified place or area, unless the court finds on the record that extraordinary circumstances exist that would make such condition plainly unreasonable, in which event the court shall impose one or more other conditions set forth in 18 U.S.C. § 3563(b).

Note:

Section 3563(a)(2) of Title 18, United States Code, provides that, absent unusual circumstances, a defendant convicted of a felony shall abide by at least one of the conditions set forth in 18 U.S.C. § 3563(b)(2), (b)(3), and (b)(13). Before the enactment of the Antiterrorism and Effective Death Penalty Act of 1996, those conditions were a fine ((b)(2)), an order of restitution ((b)(3)), and community service ((b)(13)). Whether or not the change was intended, the Act deleted the fine condition and renumbered the restitution and community service conditions in 18 U.S.C. § 3563(b), but failed to make a corresponding change in the referenced paragraphs under 18 U.S.C. § 3563(a)(2). Accordingly, the conditions now referenced are restitution ((b)(2)), notice to victims pursuant to 18 U.S.C. § 3555 ((b)(3)), and an order that the defendant reside, or refrain from residing, in a specified place or area ((b)(13)).

(c) The court may impose other conditions that (1) are reasonably related to the nature and circumstances of the offense or the history and characteristics of the organization; and (2) involve only such deprivations of liberty or property as are necessary to effect the purposes of sentencing.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 1997 (see Appendix C, amendment 569).

§ 8D1.4. Recommended Conditions of Probation - Organizations (Policy Statement)

(a) The court may order the organization, at its expense and in the format and media specified by the court, to publicize the nature of the offense committed, the fact of conviction, the nature of the punishment imposed, and the steps that will be taken to prevent the recurrence of similar offenses.

(b) If probation is imposed under § 8D1.1(a)(2), the following conditions may be appropriate to the extent they appear necessary to safeguard the organization's ability to pay any deferred portion of an order of restitution, fine, or assessment:

(1) The organization shall make periodic submissions to the court or probation officer, at intervals specified by the court, reporting on the organization's financial condition and results of business operations, and accounting for the disposition of all funds received.

(2) The organization shall submit to: (A) a reasonable number of regular or unannounced examinations of its books and records at appropriate business premises by the probation officer or experts engaged by the court; and (B) interrogation of knowledgeable individuals within the organization. Compensation to and costs of any experts engaged by the court shall be paid by the organization.

(3) The organization shall be required to notify the court or probation officer immediately upon learning of (A) any material adverse change in its business or financial condition or prospects, or (B) the commencement of any bankruptcy proceeding, major civil litigation, criminal prosecution, or administrative proceeding against the organization, or any investigation or formal inquiry by governmental authorities regarding the organization.

(4) The organization shall be required to make periodic payments, as specified by the court, in the following priority: (A) restitution; (B) fine; and (C) any other monetary sanction.

(c) If probation is ordered under § 8D1.1(a)(3), (4), (5), or (6), the following conditions may be appropriate:

(1) The organization shall develop and submit to the court an effective compliance and ethics program consistent with § 8B2.1 (Effective Compliance and Ethics Program). The organization shall include in its submission a schedule for implementation of the compliance and ethics program.

(2) Upon approval by the court of a program referred to in subdivision (1), the organization shall notify its employees and shareholders of its criminal behavior and its program referred to in subdivision (1). Such notice shall be in a form prescribed by the court.

(3) The organization shall make periodic reports to the court or probation officer, at intervals and in a form specified by the court, regarding the organization's progress in implementing the program referred to in subdivision (1). Among other things, such reports shall disclose any criminal prosecution, civil litigation, or administrative proceeding commenced against the organization, or any investigation or formal inquiry by

governmental authorities of which the organization learned since its last report.

(4) In order to monitor whether the organization is following the program referred to in subdivision (1), the organization shall submit to: (A) a reasonable number of regular or unannounced examinations of its books and records at appropriate business premises by the probation officer or experts engaged by the court; and (B) interrogation of knowledgeable individuals within the organization. Compensation to and costs of any experts engaged by the court shall be paid by the organization.

Commentary

Application Note:

1. In determining the conditions to be imposed when probation is ordered under § 8D1.1(a)(3) through (6), the court should consider the views of any governmental regulatory body that oversees conduct of the organization relating to the instant offense. To assess the efficacy of a compliance and ethics program submitted by the organization, the court may employ appropriate experts who shall be afforded access to all material possessed by the organization that is necessary for a comprehensive assessment of the proposed program. The court should approve any program that appears reasonably calculated to prevent and detect criminal conduct, as long as it is consistent with § 8B2.1 (Effective Compliance and Ethics Program), and any applicable statutory and regulatory requirements.

Periodic reports submitted in accordance with subsection (c)(3) should be provided to any governmental regulatory body that oversees conduct of the organization relating to the instant offense.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422). Amended effective November 1, 2004 (see Appendix C, amendment 673).

§ 8D1.5. [Deleted]

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422); was moved to § 8F1.1 effective November 1, 2004 (see Appendix C, amendment 673).

PART E - SPECIAL ASSESSMENTS, FORFEITURES, AND COSTS

§ 8E1.1. Special Assessments - Organizations

A special assessment must be imposed on an organization in the amount prescribed by statute.

Commentary

Application Notes:

1. This guideline applies if the defendant is an organization. It does not apply if the defendant is an individual. See § 5E1.3 for special assessments applicable to individuals.

2. The following special assessments are provided by statute (see 18 U.S.C. § 3013):

For Offenses Committed By Organizations On Or After April 24, 1996:

- (A) \$400, if convicted of a felony;
- (B) \$125, if convicted of a Class A misdemeanor;
- (C) \$50, if convicted of a Class B misdemeanor; or
- (D) \$25, if convicted of a Class C misdemeanor or an infraction.

For Offenses Committed By Organizations On Or After November 18, 1988 But Prior To April 24, 1996:

- (E) \$200, if convicted of a felony;
- (F) \$125, if convicted of a Class A misdemeanor;
- (G) \$50, if convicted of a Class B misdemeanor; or
- (H) \$25, if convicted of a Class C misdemeanor or an infraction.

For Offenses Committed By Organizations Prior To November 18, 1988:

- (I) \$200, if convicted of a felony;
- (J) \$100, if convicted of a misdemeanor.

3. A special assessment is required by statute for each count of conviction.

Background: Section 3013 of Title 18, United States Code, added by The Victims of Crimes Act of 1984, Pub. L. No. 98-473, Title II, Chap. XIV, requires courts to impose special assessments on convicted defendants for the purpose of funding the Crime Victims Fund established by the same legislation.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422); November 1, 1997 (see Appendix C, amendment 573).

§ 8E1.2. Forfeiture - Organizations

Apply § 5E1.4 (Forfeiture).

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

§ 8E1.3. Assessment of Costs - Organizations

As provided in 28 U.S.C. § 1918, the court may order the organization to pay the costs of prosecution. In addition, specific statutory provisions mandate assessment of costs.

Historical Note: Effective November 1, 1991 (see Appendix C, amendment 422).

PART F - VIOLATIONS OF PROBATION - ORGANIZATIONS

Historical Note: Effective November 1, 2004 (see Appendix C, amendment 673).

§ 8F1.1. Violations of Conditions of Probation - Organizations (Policy Statement)

Upon a finding of a violation of a condition of probation, the court may extend the term of probation, impose more restrictive conditions of probation, or revoke probation and resentence the organization.

Commentary

Application Notes:

- 1. Appointment of Master or Trustee. --In the event of repeated violations of conditions of probation, the appointment of a master or trustee may be appropriate to ensure compliance with court orders.*
- 2. Conditions of Probation.--Mandatory and recommended conditions of probation are specified in §§ 8D1.3 (Conditions of Probation - Organizations) and 8D1.4 (Recommended Conditions of Probation - Organizations).*

Historical Note: Effective November 1, 2004 (see Appendix C, amendment 673).



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Corporate Governance: Law and Practice

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Appendix 13-B The Filip Memorandum

2-13-B Corporate Governance: Law and Practice Appendix 13-B.syn

§ 13-B.syn Synopsis to Appendix 13-B: The Filip Memorandum

13-B The Filip Memorandum



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Appendix 13-B The Filip Memorandum

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13-B The Filip Memorandum

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July 9, 2008

The Honorable Patrick J. Leahy
Chairman
Committee on the Judiciary
United States Senate
Washington, DC 20510

The Honorable Arlen Specter
Ranking Member
Committee on the Judiciary
United States Senate
Washington, DC 20510

Dear Chairman Leahy and Senator Specter:

At your request during my confirmation proceedings last year, I committed to review the Department of Justice's Principles of Federal Prosecution of Business Organizations ("Principles"), the internal policy that governs how all federal prosecutors investigate, charge, and prosecute corporate crimes. I write to update you on my review, and to provide you with a summary of certain changes to the Principles that the Department intends to make in the coming weeks to address issues you have raised and that were echoed during my review. I respectfully ask that you give us an opportunity to implement these changes and then review their operation after a reasonable amount of time before pursuing legislation in this area.

As you are aware, some have raised concerns about the effect of the Principles on the preservation of the attorney-client

privilege and work product protection. Specifically and most notably, some have argued that the Department has used the threat of criminal indictment and prosecution (or the threat of withholding cooperation credit) to coerce corporations to waive privilege or work product protection against their will and to provide information to the government that otherwise would be subject to these protections. Others have argued that the perceived widespread use of privilege waivers has inhibited candid communications between corporate employees and legal counsel whose advice has been sought. Additionally, some have expressed concern that the Principles improperly permit the government to limit or refuse cooperation credit to a corporation if the corporation has advanced attorneys' fees to its employees, failed to sanction or fire allegedly culpable employees, or entered into joint defense agreements.

In response to these and other concerns, senior attorneys in the Department and I met internally and with several organizations and former government officials who expressed an interest in this issue, including representatives of the corporate community, criminal defense attorneys, in-house counsel, and civil liberties advocates. During those meetings, we discussed the matters noted above, as well as the Department's belief that we have been judicious in our limited requests for waivers. We pointed out that in the eighteen months since the Principles were last amended, the Department has approved no requests by prosecutors to obtain from corporations core attorney-client communications or non-factual attorney work product.

Despite the obvious difference of opinion between the Department and these groups in some key areas, our meetings were extremely productive and we did find common ground, particularly in the areas of joint defense agreements, attorneys' fees, and employee sanctions. I also came away impressed by the need for the Department to address any lingering perceptions that our conduct in corporate criminal investigations is anything other than fair and respectful of the attorney-client privilege. To that end, I have carefully reviewed the Principles and expect that the Department will make the following revisions to them in the next few weeks:

- Cooperation will be measured by the extent to which a corporation discloses relevant facts and evidence, not its waiver of privileges. The government's key measure of cooperation will be the same for a corporation as for an individual: to what extent has the corporation timely disclosed the relevant facts about the misconduct? That will be the operative question--*not* whether the corporation waived attorney-client privilege or work product protection in making its disclosures.
- Federal prosecutors will not demand the disclosure of "Category II" information as a condition for cooperation credit. To be eligible for cooperation credit, a corporation need not disclose, and the government may not demand, what the McNulty Memo defines as "Category II information"--namely, non-factual attorney work product and core attorney-client privileged communications. (Of course, attorney-client communications that were made in furtherance of a crime or fraud, or that relate to an advice-of-counsel defense, are excluded from the protection of the privilege by well-settled case law and will therefore continue to fall outside these principles.)
- Federal prosecutors will not consider whether the corporation has advanced attorneys' fees to its employees in evaluating cooperation. The advancement of attorneys' fees or provision of counsel by a corporation to its employees will not be taken into account for the purpose of evaluating cooperation.
- Federal prosecutors will not consider whether the corporation has entered into a joint defense agreement in evaluating cooperation. The mere participation in a joint defense, common interest, or similar agreement by a corporation will not be taken into account for the purpose of evaluating cooperation. The government may, of course, request that a corporation refrain from disclosing to others sensitive information about the investigation that the government provides in confidence to the corporation, and may consider whether the corporation has abided by that request.
- Federal prosecutors will not consider whether the corporation has retained or sanctioned employees

in evaluating cooperation. How and whether a corporation disciplines culpable employees may bear on the quality of its remedial measures or its compliance program; it will not be taken into account for the purpose of evaluating cooperation.

During my tenure as Deputy Attorney General, I have appreciated the courtesy you have extended to me and to the Department, particularly your patience during my review of this important issue. I have come to the conclusion that the above changes to the Principles are preferable to any legislation, however well intentioned and diligently drafted, that would seek to address the same core set of issues. I think we all very much share an appreciation for the foundational role that the attorney-client privilege plays in our legal system, including our system of criminal justice. The interest that you both have shown in this matter, including your vigilance in protecting the attorney-client privilege, certainly has motivated the Department to pursue the changes I have outlined above.

I remain available to discuss this matter with you further at your convenience. Thank you again for considering our views.

Sincerely,
 Mark Filip
 Deputy Attorney General

9-28.000 Principles of Federal Prosecution of Business Organizations 1

9-28.100 Duties of Federal Prosecutors and Duties of Corporate Leaders

The prosecution of corporate crime is a high priority for the Department of Justice. By investigating allegations of wrongdoing and by bringing charges where appropriate for criminal misconduct, the Department promotes critical public interests. These interests include, to take just a few examples: (1) protecting the integrity of our free economic and capital markets; (2) protecting consumers, investors, and business entities that compete only through lawful means; and (3) protecting the American people from misconduct that would violate criminal laws safeguarding the environment.

In this regard, federal prosecutors and corporate leaders typically share common goals. For example, directors and officers owe a fiduciary duty to a corporation's shareholders, the corporation's true owners, and they owe duties of honest dealing to the investing public in connection with the corporation's regulatory filings and public statements. The faithful execution of these duties by corporate leadership serves the same values in promoting public trust and confidence that our criminal cases are designed to serve.

A prosecutor's duty to enforce the law requires the investigation and prosecution of criminal wrongdoing if it is discovered. In carrying out this mission with the diligence and resolve necessary to vindicate the important public interests discussed above, prosecutors should be mindful of the common cause we share with responsible corporate leaders. Prosecutors should also be mindful that confidence in the Department is affected both by the results we achieve and by the real and perceived ways in which we achieve them. Thus, the manner in which we do our job as prosecutors--including the professionalism we demonstrate, our willingness to secure the facts in a manner that encourages corporate compliance and self-regulation, and also our appreciation that corporate prosecutions can potentially harm blameless investors, employees, and others--affects public perception of our mission. Federal prosecutors recognize that they must maintain public confidence in the way in which they exercise their charging discretion. This endeavor requires the thoughtful analysis of all facts and circumstances presented in a given case. As always, professionalism and civility play an important part in the Department's discharge of its responsibilities in all areas, including the area of corporate investigations and prosecutions.

A. General Principle: Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate, results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government

to be a force for positive change of corporate culture, and a force to prevent, discover, and punish serious crimes.^B
 Comment: In all cases involving corporate wrongdoing, prosecutors should consider the factors discussed further below. In doing so, prosecutors should be aware of the public benefits that can flow from indicting a corporation in appropriate cases. For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal misconduct that is pervasive throughout a particular industry, and thus an indictment can provide a unique opportunity for deterrence on a broad scale. In addition, a corporate indictment may result in specific deterrence by changing the culture of the indicted corporation and the behavior of its employees. Finally, certain crimes that carry with them a substantial risk of great public harm--e.g., environmental crimes or sweeping financial frauds--may be committed by a business entity, and there may therefore be a substantial federal interest in indicting a corporation under such circumstances.

In certain instances, it may be appropriate, upon consideration of the factors set forth herein, to resolve a corporate criminal case by means other than indictment. Non-prosecution and deferred prosecution agreements, for example, occupy an important middle ground between declining prosecution and obtaining the conviction of a corporation. These agreements are discussed further in Section X, *infra*. Likewise, civil and regulatory alternatives may be appropriate in certain cases, as discussed in Section XI, *infra*.

Where a decision is made to charge a corporation, it does not necessarily follow that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. Because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, particularly if it relates to high-level corporate officers, even in the face of an offer of a corporate guilty plea or some other disposition of the charges against the corporation.

Corporations are "legal persons," capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents. To hold a corporation liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should not limit their focus solely to individuals or the corporation, but should consider both as potential targets.

Agents may act for mixed reasons--both for self-aggrandizement (both direct and indirect) and for the benefit of the corporation, and a corporation may be held liable as long as one motivation of its agent is to benefit the corporation. *See United States v. Potter*, 463 F.3d 9, 25 (1st Cir. 2006) (stating that the test to determine whether an agent is acting within the scope of employment is "whether the agent is performing acts of the kind which he is authorized to perform, and those acts are motivated, at least in part, by an intent to benefit the corporation."). In *United States v. Automated Medical Laboratories, Inc.*, 770 F.2d 399 (4th Cir. 1985), for example, the Fourth Circuit affirmed a corporation's conviction for the actions of a subsidiary's employee despite the corporation's claim that the employee was acting for his own benefit, namely his "ambitious nature and his desire to ascend the corporate ladder." *Id.* at 407. The court stated, "Partucci was clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being and its lack of difficulties with the FDA." *Id.*; *see also United States v. Cincotta*, 689 F.2d 238, 241-42 (1st Cir. 1982) (upholding a corporation's conviction, notwithstanding the substantial personal benefit reaped by its miscreant agents, because the fraudulent scheme required money to pass through the corporation's treasury and the fraudulently obtained goods were resold to the corporation's customers in the corporation's name).

Moreover, the corporation need not even necessarily profit from its agent's actions for it to be held liable. In *Automated Medical Laboratories*, the Fourth Circuit stated:

[B]enefit is not a "touchstone of criminal corporate liability; benefit at best is an evidential, not an

operative, fact." Thus, whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation. The basic purpose of requiring that an agent have acted with the intent to benefit the corporation, however, is to insulate the corporation from criminal liability for actions of its agents which may be *inimical* to the interests of the corporation or which may have been undertaken solely to advance the interests of that agent or of a party other than the corporation.

770 F.2d at 407 (internal citation omitted) (quoting *Old Monastery Co. v. United States*, 147 F.2d 905, 908 (4th Cir. 1945)). A. General Principle: Generally, prosecutors apply the same factors in determining whether to charge a corporation as they do with respect to individuals. See US AM § 9-27.220, *et seq.* Thus, the prosecutor must weigh all of the factors normally considered in the sound exercise of prosecutorial judgment: the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of noncriminal approaches. See *id.* However, due to the nature of the corporate "person," some additional factors are present. In conducting an investigation, determining whether to bring charges, and negotiating plea or other agreements, prosecutors should consider the following factors in reaching a decision as to the proper treatment of a corporate target:

1. the nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime (*see infra* section IV);
2. the pervasiveness of wrongdoing within the corporation, including the complicity in, or the condoning of, the wrongdoing by corporate management (*see infra* section V);
3. the corporation's history of similar misconduct, including prior criminal, civil, and regulatory enforcement actions against it (*see infra* section VI);
4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents (*see infra* section VII);
5. the existence and effectiveness of the corporation's pre-existing compliance program (*see infra* section VIII);
6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies (*see infra* section IX);
7. collateral consequences, including whether there is disproportionate harm to shareholders, pension holders, employees, and others not proven personally culpable, as well as impact on the public arising from the prosecution (*see infra* section X);
8. the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and
9. the adequacy of remedies such as civil or regulatory enforcement actions (*see infra* section XI).

B. Comment: The factors listed in this section are intended to be illustrative of those that should be evaluated and are not an exhaustive list of potentially relevant considerations. Some of these factors may not apply to specific cases, and in some cases one factor may override all others. For example, the nature and seriousness of the offense may be such as to warrant prosecution regardless of the other factors. In most cases, however, no single factor will be dispositive. In addition, national law enforcement policies in various enforcement areas may require that more or less weight be given

to certain of these factors than to others. Of course, prosecutors must exercise their thoughtful and pragmatic judgment in applying and balancing these factors, so as to achieve a fair and just outcome and promote respect for the law.

In making a decision to charge a corporation, the prosecutor generally has substantial latitude in determining when, whom, how, and even whether to prosecute for violations of federal criminal law. In exercising that discretion, prosecutors should consider the following statements of principles that summarize the considerations they should weigh and the practices they should follow in discharging their prosecutorial responsibilities. In doing so, prosecutors should ensure that the general purposes of the criminal law--assurance of warranted punishment, deterrence of further criminal conduct, protection of the public from dangerous and fraudulent conduct, rehabilitation of offenders, and restitution for victims and affected communities--are adequately met, taking into account the special nature of the corporate "person."

A. General Principle: The nature and seriousness of the crime, including the risk of harm to the public from the criminal misconduct, are obviously primary factors in determining whether to charge a corporation. In addition, corporate conduct, particularly that of national and multi-national corporations, necessarily intersects with federal economic, tax, and criminal law enforcement policies. In applying these Principles, prosecutors must consider the practices and policies of the appropriate Division of the Department, and must comply with those policies to the extent required by the facts presented.

B. Comment: In determining whether to charge a corporation, prosecutors should take into account federal law enforcement priorities as discussed above. *See* USAM § 9-27-230. In addition, however, prosecutors must be aware of the specific policy goals and incentive programs established by the respective Divisions and regulatory agencies. Thus, whereas natural persons may be given incremental degrees of credit (ranging from immunity to lesser charges to sentencing considerations) for turning themselves in, making statements against their penal interest, and cooperating in the government's investigation of their own and others' wrongdoing, the same approach may not be appropriate in all circumstances with respect to corporations. As an example, it is entirely proper in many investigations for a prosecutor to consider the corporation's pre-indictment conduct, *e.g.*, voluntary disclosure, cooperation, remediation or restitution, in determining whether to seek an indictment. However, this would not necessarily be appropriate in an antitrust investigation, in which antitrust violations, by definition, go to the heart of the corporation's business. With this in mind, the Antitrust Division has established a firm policy, understood in the business community, that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government. As another example, the Tax Division has a strong preference for prosecuting responsible individuals, rather than entities, for corporate tax offenses. Thus, in determining whether or not to charge a corporation, prosecutors must consult with the Criminal, Antitrust, Tax, Environmental and Natural Resources, and National Security Divisions, as appropriate.

A. General Principle: A corporation can only act through natural persons, and it is therefore held responsible for the acts of such persons fairly attributable to it. Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees, or by all the employees in a particular role within the corporation, or was condoned by upper management. On the other hand, it may not be appropriate to impose liability upon a corporation, particularly one with a robust compliance program in place, under a strict *respondeat superior* theory for the single isolated act of a rogue employee. There is, of course, a wide spectrum between these two extremes, and a prosecutor should exercise sound discretion in evaluating the pervasiveness of wrongdoing within a corporation.

B. Comment: Of these factors, the most important is the role and conduct of management. Although acts of even low-level employees may result in criminal liability, a corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged. As stated in commentary to the Sentencing Guidelines:

Pervasiveness [is] case specific and [will] depend on the number, and degree of responsibility, of individuals [with] substantial authority ... who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an organization.

USSG § 8C2.5, cmt. (n. 4). **A. General Principle:** Prosecutors may consider a corporation's history of similar conduct,

including prior criminal, civil, and regulatory enforcement actions against it, in determining whether to bring criminal charges and how best to resolve cases. B. Comment: A corporation, like a natural person, is expected to learn from its mistakes. A history of similar misconduct may be probative of a corporate culture that encouraged, or at least condoned, such misdeeds, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and it either had not taken adequate action to prevent future unlawful conduct or had continued to engage in the misconduct in spite of the warnings or enforcement actions taken against it. The corporate structure itself (*e.g.*, the creation or existence of subsidiaries or operating divisions) is not dispositive in this analysis, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates may be considered, if germane. *See* USSG § 8C2.5(c), cmt. (n. 6). A. General Principle: In determining whether to charge a corporation and how to resolve corporate criminal cases, the corporation's timely and voluntary disclosure of wrongdoing and its cooperation with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider, among other things, whether the corporation made a voluntary and timely disclosure, and the corporation's willingness to provide relevant information and evidence and identify relevant actors within and outside the corporation, including senior executives.

Cooperation is a potential mitigating factor, by which a corporation--just like any other subject of a criminal investigation--can gain credit in a case that otherwise is appropriate for indictment and prosecution. Of course, the decision not to cooperate by a corporation (or individual) is not itself evidence of misconduct, at least where the lack of cooperation does not involve criminal misconduct or demonstrate consciousness of guilt (*e.g.*, suborning perjury or false statements, or refusing to comply with lawful discovery requests). Thus, failure to cooperate, in and of itself, does not support or require the filing of charges with respect to a corporation any more than with respect to an individual. B. Comment: In investigating wrongdoing by or within a corporation, a prosecutor is likely to encounter several obstacles resulting from the nature of the corporation itself. It will often be difficult to determine which individual took which action on behalf of the corporation. Lines of authority and responsibility may be shared among operating divisions or departments, and records and personnel may be spread throughout the United States or even among several countries. Where the criminal conduct continued over an extended period of time, the culpable or knowledgeable personnel may have been promoted, transferred, or fired, or they may have quit or retired. Accordingly, a corporation's cooperation may be critical in identifying potentially relevant actors and locating relevant evidence, among other things, and in doing so expeditiously.

This dynamic--*i.e.*, the difficulty of determining what happened, where the evidence is, and which individuals took or promoted putatively illegal corporate actions--can have negative consequences for both the government and the corporation that is the subject or target of a government investigation. More specifically, because of corporate attribution principles concerning actions of corporate officers and employees (*see, e.g., supra* section II), uncertainty about exactly who authorized or directed apparent corporate misconduct can inure to the detriment of a corporation. For example, it may not matter under the law which of several possible executives or leaders in a chain of command approved of or authorized criminal conduct; however, that information if known might bear on the propriety of a particular disposition short of indictment of the corporation. It may not be in the interest of a corporation or the government for a charging decision to be made in the absence of such information, which might occur if, for example, a statute of limitations were relevant and authorization by any one of the officials were enough to justify a charge under the law. Moreover, and at a minimum, a protracted government investigation of such an issue could, as a collateral consequence, disrupt the corporation's business operations or even depress its stock price.

For these reasons and more, cooperation can be a favorable course for both the government and the corporation. Cooperation benefits the government--and ultimately shareholders, employees, and other often blameless victims--by allowing prosecutors and federal agents, for example, to avoid protracted delays, which compromise their ability to quickly uncover and address the full extent of widespread corporate crimes. With cooperation by the corporation, the government may be able to reduce tangible losses, limit damage to reputation, and preserve assets for restitution. At the same time, cooperation may benefit the corporation by enabling the government to focus its investigative resources in a

manner that will not unduly disrupt the corporation's legitimate business operations. In addition, and critically, cooperation may benefit the corporation by presenting it with the opportunity to earn credit for its efforts.^{9-28.710}Attorney-Client and Work Product Protections

The attorney-client privilege and the attorney work product protection serve an extremely important function in the American legal system. The attorney-client privilege is one of the oldest and most sacrosanct privileges under the law. *See Upjohn v. United States*, 449 U.S. 383, 389 (1981). As the Supreme Court has stated, "[i]ts purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice." *Id.* The value of promoting a corporation's ability to seek frank and comprehensive legal advice is particularly important in the contemporary global business environment, where corporations often face complex and dynamic legal and regulatory obligations imposed by the federal government and also by states and foreign governments. The work product doctrine serves similarly important goals.

For these reasons, waiving the attorney-client and work product protections has never been a prerequisite under the Department's prosecution guidelines for a corporation to be viewed as cooperative. Nonetheless, a wide range of commentators and members of the American legal community and criminal justice system have asserted that the Department's policies have been used, either wittingly or unwittingly, to coerce business entities into waiving attorney-client privilege and work-product protection. Everyone agrees that a corporation may freely waive its own privileges if it chooses to do so; indeed, such waivers occur routinely when corporations are victimized by their employees or others, conduct an internal investigation, and then disclose the details of the investigation to law enforcement officials in an effort to seek prosecution of the offenders. However, the contention, from a broad array of voices, is that the Department's position on attorney-client privilege and work product protection waivers has promoted an environment in which those protections are being unfairly eroded to the detriment of all.

The Department understands that the attorney-client privilege and attorney work product protection are essential and long-recognized components of the American legal system. What the government seeks and needs to advance its legitimate (indeed, essential) law enforcement mission is not waiver of those protections, but rather the facts known to the corporation about the putative criminal misconduct under review. In addition, while a corporation remains free to convey non-factual or "core" attorney-client communications or work product--if and only if the corporation voluntarily chooses to do so--prosecutors should not ask for such waivers and are directed not to do so. The critical factor is whether the corporation has provided the facts about the events, as explained further herein.

Eligibility for cooperation credit is not predicated upon the waiver of attorney-client privilege or work product protection. Instead, the sort of cooperation that is most valuable to resolving allegations of misconduct by a corporation and its officers, directors, employees, or agents is disclosure of the relevant *facts* concerning such misconduct. In this regard, the analysis parallels that for a non-corporate defendant, where cooperation typically requires disclosure of relevant factual knowledge and not of discussions between an individual and his attorneys.

Thus, when the government investigates potential corporate wrongdoing, it seeks the relevant facts. For example, how and when did the alleged misconduct occur? Who promoted or approved it? Who was responsible for committing it? In this respect, the investigation of a corporation differs little from the investigation of an individual. In both cases, the government needs to know the facts to achieve a just and fair outcome. The party under investigation may choose to cooperate by disclosing the facts, and the government may give credit for the party's disclosures. If a corporation wishes to receive credit for such cooperation, which then can be considered with all other cooperative efforts and circumstances in evaluating how fairly to proceed, then the corporation, like any person, must disclose the relevant facts of which it has knowledge.ⁿ² (a)Disclosing the Relevant Facts--Facts Gathered Through Internal Investigation

Individuals and corporations often obtain knowledge of facts in different ways. An individual knows the facts of his or others' misconduct through his own experience and perceptions. A corporation is an artificial construct that cannot, by definition, have personal knowledge of the facts. Some of those facts may be reflected in documentary or electronic

media like emails, transaction or accounting documents, and other records. Often, the corporation gathers facts through an internal investigation. Exactly how and by whom the facts are gathered is for the corporation to decide. Many corporations choose to collect information about potential misconduct through lawyers, a process that may confer attorney-client privilege or attorney work product protection on at least some of the information collected. Other corporations may choose a method of fact-gathering that does not have that effect--for example, having employee or other witness statements collected after interviews by non-attorney personnel.

Whichever process the corporation selects, the government's key measure of cooperation must remain the same as it does for an individual: has the party timely disclosed the relevant facts about the putative misconduct? That is the operative question in assigning cooperation credit for the disclosure of information--*not* whether the corporation discloses attorney-client or work product materials. Accordingly, a corporation should receive the same credit for disclosing facts contained in materials that are not protected by the attorney-client privilege or attorney work product as it would for disclosing identical facts contained in materials that are so protected.³ On this point the Report of the House Judiciary Committee, submitted in connection with the attorney-client privilege bill passed by the House of Representatives (H.R. 3013), comports with the approach required here:

[A]n ... attorney of the United States may base cooperation credit on the facts that are disclosed, but is prohibited from basing cooperation credit upon whether or not the materials are protected by attorney-client privilege or attorney work product. As a result, an entity that voluntarily discloses should receive the same amount of cooperation credit for disclosing facts that happen to be contained in materials not protected by attorney-client privilege or attorney work product as it would receive for disclosing identical facts that are contained in materials protected by attorney-client privilege or attorney work product. There should be no differentials in an assessment of cooperation (*i.e.*, neither a credit nor a penalty) based upon whether or not the materials disclosed are protected by attorney-client privilege or attorney work product.

H.R. Rep. No. 110-445 at 4 (2007).

In short, so long as the corporation timely discloses relevant facts about the putative misconduct, the corporation may receive due credit for such cooperation, regardless of whether it chooses to waive privilege or work product protection in the process.⁴ Likewise, a corporation that does not disclose the relevant facts about the alleged misconduct--for whatever reason--typically should not be entitled to receive credit for cooperation.

Two final and related points bear noting about the disclosure of facts, although they should be obvious. First, the government cannot compel, and the corporation has no obligation to make, such disclosures (although the government can obviously compel the disclosure of certain records and witness testimony through subpoenas). Second, a corporation's failure to provide relevant information does not mean the corporation will be indicted. It simply means that the corporation will not be entitled to mitigating credit for that cooperation. Whether the corporation faces charges will turn, as it does in any case, on the sufficiency of the evidence, the likelihood of success at trial, and all of the other factors identified in Section III above. If there is insufficient evidence to warrant indictment, after appropriate investigation has been completed, or if the other factors weigh against indictment, then the corporation should not be indicted, irrespective of whether it has earned cooperation credit. The converse is also true: The government may charge even the most cooperative corporation pursuant to these Principles if, in weighing and balancing the factors described herein, the prosecutor determines that a charge is required in the interests of justice. Put differently, even the most sincere and thorough effort to cooperate cannot necessarily absolve a corporation that has, for example, engaged in an egregious, orchestrated, and widespread fraud. Cooperation is a relevant potential mitigating factor, but it alone is not dispositive.

Separate from (and usually preceding) the fact-gathering process in an internal investigation, a corporation, through its officers, employees, directors, or others, may have consulted with corporate counsel regarding or in a manner that

concerns the legal implications of the putative misconduct at issue. Communications of this sort, which are both independent of the fact-gathering component of an internal investigation and made for the purpose of seeking or dispensing legal advice, lie at the core of the attorney-client privilege. Such communications can naturally have a salutary effect on corporate behavior--facilitating, for example, a corporation's effort to comply with complex and evolving legal and regulatory regimes.⁵ Except as noted in subparagraphs (b)(i) and (b)(ii) below, a corporation need not disclose and prosecutors may not request the disclosure of such communications as a condition for the corporation's eligibility to receive cooperation credit.

Likewise, non-factual or core attorney work product--for example, an attorney's mental impressions or legal theories--lies at the core of the attorney work product doctrine. A corporation need not disclose, and prosecutors may not request, the disclosure of such attorney work product as a condition for the corporation's eligibility to receive cooperation credit.⁽ⁱ⁾Advice of Counsel Defense in the Instant Context

Occasionally a corporation or one of its employees may assert an advice-of-counsel defense, based upon communications with in-house or outside counsel that took place prior to or contemporaneously with the underlying conduct at issue. In such situations, the defendant must tender a legitimate factual basis to support the assertion of the advice-of-counsel defense. *See, e.g., Pitt v. Dist. of Columbia*, 491 F.3d 494, 504-05 (D.C. Cir. 2007) ; *United States v. Wenger*, 427 F.3d 840, 853-54 (10th Cir. 2005); *United States v. Cheek*, 3 F.3d 1057, 1061-62 (7th Cir. 1993) . The Department cannot fairly be asked to discharge its responsibility to the public to investigate alleged corporate crime, or to temper what would otherwise be the appropriate course of prosecutive action, by simply accepting on faith an otherwise unproven assertion that an attorney--perhaps even an unnamed attorney--approved potentially unlawful practices. Accordingly, where an advice-of-counsel defense has been asserted, prosecutors may ask for the disclosure of the communications allegedly supporting it.⁽ⁱⁱ⁾Communications in Furtherance of a Crime or Fraud

Communications between a corporation (through its officers, employees, directors, or agents) and corporate counsel that are made in furtherance of a crime or fraud are, under settled precedent, outside the scope and protection of the attorney-client privilege. *See United States v. Zolin*, 491 U.S. 554, 563 (1989) ; *United States v. BDO Seidman, LLP*, 492 F.3d 806, 818 (7th Cir. 2007) . As a result, the Department may properly request such communications if they in fact exist.^{9-28.730}Obstructing the Investigation

Another factor to be weighed by the prosecutor is whether the corporation has engaged in conduct intended to impede the investigation. Examples of such conduct could include: inappropriate directions to employees or their counsel, such as directions not to be truthful or to conceal relevant facts; making representations or submissions that contain misleading assertions or material omissions; and incomplete or delayed production of records.

In evaluating cooperation, however, prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees or providing counsel to employees, officers, or directors under investigation or indictment. Likewise, prosecutors may not request that a corporation refrain from taking such action. This prohibition is not meant to prevent a prosecutor from asking questions about an attorney's representation of a corporation or its employees, officers, or directors, where otherwise appropriate under the law.⁶ Neither is it intended to limit the otherwise applicable reach of criminal obstruction of justice statutes such as *18 U.S.C. § 1503*. If the payment of attorney fees were used in a manner that would otherwise constitute criminal obstruction of justice--for example, if fees were advanced on the condition that an employee adhere to a version of the facts that the corporation and the employee knew to be false--these Principles would not (and could not) render inapplicable such criminal prohibitions.

Similarly, the mere participation by a corporation in a joint defense agreement does not render the corporation ineligible to receive cooperation credit, and prosecutors may not request that a corporation refrain from entering into such agreements. Of course, the corporation may wish to avoid putting itself in the position of being disabled, by virtue of a particular joint defense or similar agreement, from providing some relevant facts to the government and thereby limiting its ability to seek such cooperation credit. Such might be the case if the corporation gathers facts from employees who

have entered into a joint defense agreement with the corporation, and who may later seek to prevent the corporation from disclosing the facts it has acquired. Corporations may wish to address this situation by crafting or participating in joint defense agreements, to the extent they choose to enter them, that provide such flexibility as they deem appropriate.

Finally, it may on occasion be appropriate for the government to consider whether the corporation has shared with others sensitive information about the investigation that the government provided to the corporation. In appropriate situations, as it does with individuals, the government may properly request that, if a corporation wishes to receive credit for cooperation, the information provided by the government to the corporation not be transmitted to others—for example, where the disclosure of such information could lead to flight by individual subjects, destruction of evidence, or dissipation or concealment of assets.^{9-28.740}Offering Cooperation: No Entitlement to Immunity

A corporation's offer of cooperation or cooperation itself does not automatically entitle it to immunity from prosecution or a favorable resolution of its case. A corporation should not be able to escape liability merely by offering up its directors, officers, employees, or agents. Thus, a corporation's willingness to cooperate is not determinative; that factor, while relevant, needs to be considered in conjunction with all other factors.^{9-28.750}Qualifying for Immunity, Amnesty, or Reduced Sanctions Through Voluntary Disclosures

In conjunction with regulatory agencies and other executive branch departments, the Department encourages corporations, as part of their compliance programs, to conduct internal investigations and to disclose the relevant facts to the appropriate authorities. Some agencies, such as the Securities and Exchange Commission and the Environmental Protection Agency, as well as the Department's Environmental and Natural Resources Division, have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions. Even in the absence of a formal program, prosecutors may consider a corporation's timely and voluntary disclosure in evaluating the adequacy of the corporation's compliance program and its management's commitment to the compliance program. However, prosecution and economic policies specific to the industry or statute may require prosecution notwithstanding a corporation's willingness to cooperate. For example, the Antitrust Division has a policy of offering amnesty only to the first corporation to agree to cooperate. Moreover, amnesty, immunity, or reduced sanctions may not be appropriate where the corporation's business is permeated with fraud or other crimes.^{9-28.760}Oversight Concerning Demands for Waivers of Attorney-Client Privilege or Work Product Protection By Corporations Contrary to This Policy

The Department underscores its commitment to attorney practices that are consistent with Department policies like those set forth herein concerning cooperation credit and due respect for the attorney-client privilege and work product protection. Counsel for corporations who believe that prosecutors are violating such guidance are encouraged to raise their concerns with supervisors, including the appropriate United States Attorney or Assistant Attorney General. Like any other allegation of attorney misconduct, such allegations are subject to potential investigation through established mechanisms.

A. General Principle: Compliance programs are established by corporate management to prevent and detect misconduct and to ensure that corporate activities are conducted in accordance with applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal misconduct undertaken by its officers, directors, employees, or agents. In addition, the nature of some crimes, *e.g.*, antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.

B. Comment: The existence of a corporate compliance program, even one that specifically prohibited the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior*. See *United States v. Basic Constr. Co.*, 711 F.2d 570, 573 (4th Cir. 1983) ("[A] corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if... such acts were against corporate policy or express instructions."). As explained in *United States v. Potter*, 463 F.3d 9 (1st Cir. 2006), a corporation cannot "avoid liability by adopting abstract rules" that forbid its agents from engaging in illegal acts, because "[e]ven a specific directive to an

agent or employee or honest efforts to police such rules do not automatically free the company for the wrongful acts of agents." *Id.* at 25-26. See also *United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1007 (9th Cir. 1972) (noting that a corporation "could not gain exculpation by issuing general instructions without undertaking to enforce those instructions by means commensurate with the obvious risks"); *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979) ("[A] corporation may be liable for acts of its employees done contrary to express instructions and policies, but ... the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation.").

While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. The Department has no formulaic requirements regarding corporate compliance programs. The fundamental questions any prosecutor should ask are: Is the corporation's compliance program well designed? Is the program being applied earnestly and in good faith? Does the corporation's compliance program work? In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal misconduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct; and any remedial actions taken by the corporation, including, for example, disciplinary action against past violators uncovered by the prior compliance program, and revisions to corporate compliance programs in light of lessons learned.⁷ Prosecutors should also consider the promptness of any disclosure of wrongdoing to the government. In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are internal audit functions conducted at a level sufficient to ensure their independence and accuracy; and have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law. See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968-70 (Del. Ch. 1996).

Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a "paper program" or whether it was designed, implemented, reviewed, and revised, as appropriate, in an effective manner. In addition, prosecutors should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts. Prosecutors also should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it. This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation.

Compliance programs should be designed to detect the particular types of misconduct most likely to occur in a particular corporation's line of business. Many corporations operate in complex regulatory environments outside the normal experience of criminal prosecutors. Accordingly, prosecutors should consult with relevant federal and state agencies with the expertise to evaluate the adequacy of a program's design and implementation. For instance, state and federal banking, insurance, and medical boards, the Department of Defense, the Department of Health and Human Services, the Environmental Protection Agency, and the Securities and Exchange Commission have considerable experience with compliance programs and can be helpful to a prosecutor in evaluating such programs. In addition, the Fraud Section of the Criminal Division, the Commercial Litigation Branch of the Civil Division, and the Environmental Crimes Section of the Environment and Natural Resources Division can assist United States Attorneys' Offices in finding the appropriate agency office(s) for such consultation. A. General Principle: Although neither a corporation nor an individual target may avoid prosecution merely by paying a sum of money, a prosecutor may consider the

corporation's willingness to make restitution and steps already taken to do so. A prosecutor may also consider other remedial actions, such as improving an existing compliance program or disciplining wrongdoers, in determining whether to charge the corporation and how to resolve corporate criminal cases. B. Comment: In determining whether or not to prosecute a corporation, the government may consider whether the corporation has taken meaningful remedial measures. A corporation's response to misconduct says much about its willingness to ensure that such misconduct does not recur. Thus, corporations that fully recognize the seriousness of their misconduct and accept responsibility for it should be taking steps to implement the personnel, operational, and organizational changes necessary to establish an awareness among employees that criminal conduct will not be tolerated.

Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined wrongdoers, once those employees are identified by the corporation as culpable for the misconduct. Employee discipline is a difficult task for many corporations because of the human element involved and sometimes because of the seniority of the employees concerned. Although corporations need to be fair to their employees, they must also be committed, at all levels of the corporation, to the highest standards of legal and ethical behavior. Effective internal discipline can be a powerful deterrent against improper behavior by a corporation's employees. Prosecutors should be satisfied that the corporation's focus is on the integrity and credibility of its remedial and disciplinary measures rather than on the protection of the wrongdoers.

In addition to employee discipline, two other factors used in evaluating a corporation's remedial efforts are restitution and reform. As with natural persons, the decision whether or not to prosecute should not depend upon the target's ability to pay restitution. A corporation's efforts to pay restitution even in advance of any court order is, however, evidence of its acceptance of responsibility and, consistent with the practices and policies of the appropriate Division of the Department entrusted with enforcing specific criminal laws, may be considered in determining whether to bring criminal charges. Similarly, although the inadequacy of a corporate compliance program is a factor to consider when deciding whether to charge a corporation, that corporation's quick recognition of the flaws in the program and its efforts to improve the program are also factors to consider as to appropriate disposition of a case. A. General Principle: Prosecutors may consider the collateral consequences of a corporate criminal conviction or indictment in determining whether to charge the corporation with a criminal offense and how to resolve corporate criminal cases. B. Comment: One of the factors in determining whether to charge a natural person or a corporation is whether the likely punishment is appropriate given the nature and seriousness of the crime. In the corporate context, prosecutors may take into account the possibly substantial consequences to a corporation's employees, investors, pensioners, and customers, many of whom may, depending on the size and nature of the corporation and their role in its operations, have played no role in the criminal conduct, have been unaware of it, or have been unable to prevent it. Prosecutors should also be aware of non-penal sanctions that may accompany a criminal charge, such as potential suspension or debarment from eligibility for government contracts or federally funded programs such as health care programs. Determining whether or not such non-penal sanctions are appropriate or required in a particular case is the responsibility of the relevant agency, and is a decision that will be made based on the applicable statutes, regulations, and policies.

Virtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties, and the mere existence of such an effect is not sufficient to preclude prosecution of the corporation. Therefore, in evaluating the relevance of collateral consequences, various factors already discussed, such as the pervasiveness of the criminal conduct and the adequacy of the corporation's compliance programs, should be considered in determining the weight to be given to this factor. For instance, the balance may tip in favor of prosecuting corporations in situations where the scope of the misconduct in a case is widespread and sustained within a corporate division (or spread throughout pockets of the corporate organization). In such cases, the possible unfairness of visiting punishment for the corporation's crimes upon shareholders may be of much less concern where those shareholders have substantially profited, even unknowingly, from widespread or pervasive criminal activity. Similarly, where the top layers of the corporation's management or the shareholders of a closely-held corporation were engaged in or aware of the wrongdoing, and the conduct at issue was accepted as a way of doing business for an extended period, debarment may be deemed not collateral, but a direct and entirely appropriate consequence of the corporation's wrongdoing.

On the other hand, where the collateral consequences of a corporate conviction for innocent third parties would be significant, it may be appropriate to consider a non-prosecution or deferred prosecution agreement with conditions designed, among other things, to promote compliance with applicable law and to prevent recidivism. Such agreements are a third option, besides a criminal indictment, on the one hand, and a declination, on the other. Declining prosecution may allow a corporate criminal to escape without consequences. Obtaining a conviction may produce a result that seriously harms innocent third parties who played no role in the criminal conduct. Under appropriate circumstances, a deferred prosecution or non-prosecution agreement can help restore the integrity of a company's operations and preserve the financial viability of a corporation that has engaged in criminal conduct, while preserving the government's ability to prosecute a recalcitrant corporation that materially breaches the agreement. Such agreements achieve other important objectives as well, like prompt restitution for victims.⁸ Ultimately, the appropriateness of a criminal charge against a corporation, or some lesser alternative, must be evaluated in a pragmatic and reasoned way that produces a fair outcome, taking into consideration, among other things, the Department's need to promote and ensure respect for the law.

A. General Principle: Non-criminal alternatives to prosecution often exist and prosecutors may consider whether such sanctions would adequately deter, punish, and rehabilitate a corporation that has engaged in wrongful conduct. In evaluating the adequacy of non-criminal alternatives to prosecution--e.g., civil or regulatory enforcement actions--the prosecutor may consider all relevant factors, including:

1. the sanctions available under the alternative means of disposition;
2. the likelihood that an effective sanction will be imposed; and
3. the effect of non-criminal disposition on federal law enforcement interests.

B. Comment: The primary goals of criminal law are deterrence, punishment, and rehabilitation. Non-criminal sanctions may not be an appropriate response to a serious violation, a pattern of wrongdoing, or prior non-criminal sanctions without proper remediation. In other cases, however, these goals may be satisfied through civil or regulatory actions. In determining whether a federal criminal resolution is appropriate, the prosecutor should consider the same factors (modified appropriately for the regulatory context) considered when determining whether to leave prosecution of a natural person to another jurisdiction or to seek non-criminal alternatives to prosecution. These factors include: the strength of the regulatory authority's interest; the regulatory authority's ability and willingness to take effective enforcement action; the probable sanction if the regulatory authority's enforcement action is upheld; and the effect of a non-criminal disposition on federal law enforcement interests. See USAM §§ 9-27.240, 9-27.250.

A. General Principle: Once a prosecutor has decided to charge a corporation, the prosecutor at least presumptively should charge, or should recommend that the grand jury charge, the most serious offense that is consistent with the nature of the defendant's misconduct and that is likely to result in a sustainable conviction.

B. Comment: Once the decision to charge is made, the same rules as govern charging natural persons apply. These rules require "a faithful and honest application of the Sentencing Guidelines" and an "individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the Federal criminal code, and maximize the impact of Federal resources on crime." See USAM § 9-27.300. In making this determination, "it is appropriate that the attorney for the government consider, *inter alia*, such factors as the [advisory] sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range ... is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *Id.*

A. General Principle: In negotiating plea agreements with corporations, as with individuals, prosecutors should generally seek a plea to the most serious, readily provable offense charged. In addition, the terms of the plea agreement should contain appropriate provisions to ensure punishment, deterrence, rehabilitation, and compliance with the plea agreement in the corporate context. Although special circumstances may mandate a different conclusion, prosecutors generally should not agree to accept a corporate guilty plea in exchange for non-prosecution or dismissal of charges against individual officers and employees.

B. Comment: Prosecutors may enter into plea agreements with corporations for the same reasons and under the same constraints as apply to plea agreements with natural persons. See USAM §§ 9-27.400-530. This means, *inter alia*, that

the corporation should generally be required to plead guilty to the most serious, readily provable offense charged. In addition, any negotiated departures or recommended variances from the advisory Sentencing Guidelines must be justifiable under the Guidelines or 18 U.S.C. § 3553 and must be disclosed to the sentencing court. A corporation should be made to realize that pleading guilty to criminal charges constitutes an admission of guilt and not merely a resolution of an inconvenient distraction from its business. As with natural persons, pleas should be structured so that the corporation may not later "proclaim lack of culpability or even complete innocence." See USAM §§ 9-27.420(b)(4), 9-27.440, 9-27.500. Thus, for instance, there should be placed upon the record a sufficient factual basis for the plea to prevent later corporate assertions of innocence.

A corporate plea agreement should also contain provisions that recognize the nature of the corporate "person" and that ensure that the principles of punishment, deterrence, and rehabilitation are met. In the corporate context, punishment and deterrence are generally accomplished by substantial fines, mandatory restitution, and institution of appropriate compliance measures, including, if necessary, continued judicial oversight or the use of special masters or corporate monitors. See USSG §§ 8B1.1, 8C2.1, *et seq.* In addition, where the corporation is a government contractor, permanent or temporary debarment may be appropriate. Where the corporation was engaged in fraud against the government (*e.g.*, contracting fraud), a prosecutor may not negotiate away an agency's right to debar or delist the corporate defendant.

In negotiating a plea agreement, prosecutors should also consider the deterrent value of prosecutions of individuals within the corporation. Therefore, one factor that a prosecutor may consider in determining whether to enter into a plea agreement is whether the corporation is seeking immunity for its employees and officers or whether the corporation is willing to cooperate in the investigation of culpable individuals as outlined herein. Prosecutors should rarely negotiate away individual criminal liability in a corporate plea.

Rehabilitation, of course, requires that the corporation undertake to be law-abiding in the future. It is, therefore, appropriate to require the corporation, as a condition of probation, to implement a compliance program or to reform an existing one. As discussed above, prosecutors may consult with the appropriate state and federal agencies and components of the Justice Department to ensure that a proposed compliance program is adequate and meets industry standards and best practices. See *supra* section VIII.

In plea agreements in which the corporation agrees to cooperate, the prosecutor should ensure that the cooperation is entirely truthful. To do so, the prosecutor may request that the corporation make appropriate disclosures of relevant factual information and documents, make employees and agents available for debriefing, file appropriate certified financial statements, agree to governmental or third-party audits, and take whatever other steps are necessary to ensure that the full scope of the corporate wrongdoing is disclosed and that the responsible personnel are identified and, if appropriate, prosecuted. See *generally supra* section VII. In taking such steps, Department prosecutors should recognize that attorney-client communications are often essential to a corporation's efforts to comply with complex regulatory and legal regimes, and that, as discussed at length above, cooperation is not measured by the waiver of attorney-client privilege and work product protection, but rather is measured by the disclosure of facts and other considerations identified herein such as making witnesses available for interviews and assisting in the interpretation of complex documents or business records.

These Principles provide only internal Department of Justice guidance. They are not intended to, do not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal. Nor are any limitations hereby placed on otherwise lawful litigative prerogatives of the Department of Justice.

FOOTNOTES:

(n1)Footnote 1. While these guidelines refer to corporations, they apply to the consideration of the prosecution of all types of business organizations, including partnerships, sole proprietorships, government entities, and unincorporated associations.

(n5)Footnote 2. There are other dimensions of cooperation beyond the mere disclosure of facts, of course. These can include, for example, providing non-privileged documents and other evidence, making witnesses available for interviews, and assisting in the interpretation of complex business records. This section of the Principles focuses solely on the disclosure of facts and the privilege issues that may be implicated thereby.

(n6)Footnote 3. By way of example, corporate personnel are typically interviewed during an internal investigation. If the interviews are conducted by counsel for the corporation, certain notes and memoranda generated from the interviews may be subject, at least in part, to the protections of attorney-client privilege and/or attorney work product. To receive cooperation credit for providing factual information, the corporation need not produce, and prosecutors may not request, protected notes or memoranda generated by the lawyers' interviews. To earn such credit, however, the corporation does need to produce, and prosecutors may request, relevant factual information--including relevant factual information acquired through those interviews, unless the identical information has otherwise been provided--as well as relevant non-privileged evidence such as accounting and business records and emails between non-attorney employees or agents.

(n7)Footnote 4. In assessing the timeliness of a corporation's disclosures, prosecutors should apply a standard of reasonableness in light of the totality of circumstances.

(n8)Footnote 5. These privileged communications are not necessarily limited to those that occur contemporaneously with the underlying misconduct. They would include, for instance, legal advice provided by corporate counsel in an internal investigation report. Again, the key measure of cooperation is the disclosure of factual information known to the corporation, not the disclosure of legal advice or theories rendered in connection with the conduct at issue (subject to the two exceptions noted in Section VII(2)(b)(i-ii)).

(n9)Footnote 6. Routine questions regarding the representation status of a corporation and its employees, including how and by whom attorneys' fees are paid, sometimes arise in the course of an investigation under certain circumstances--to take one example, to assess conflict-of-interest issues. Such questions can be appropriate and this guidance is not intended to prohibit such limited inquiries.

(n11)Footnote 7. For a detailed review of these and other factors concerning corporate compliance programs, *see* USSG § 8B2.1.

(n13)Footnote 8. Prosecutors should note that in the case of national or multi-national corporations, multi-district or global agreements may be necessary. Such agreements may only be entered into with the approval of each affected district or the appropriate Department official. *See id.* § 9-27.641.



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Appendix 13-C Sample Code of Ethics: ASSURANT Code of Ethics

2-13-C Corporate Governance: Law and Practice Appendix 13-C.syn

§ 13-C.syn Synopsis to Appendix 13-C: Sample Code of Ethics: ASSURANT Code of Ethics

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Appendix 13-C Sample Code of Ethics: ASSURANT Code of Ethics

2-13-C Corporate Governance: Law and Practice 13-C

13-C Sample Code of Ethics: ASSURANT Code of Ethics

Asking Questions or Reporting Concerns

At Assurant, we want you to ask questions whenever you are in doubt about the right course of action, and to report any possible compliance violations or other concerns that you have.

You can seek guidance or raise concerns in several ways:

- Talk to your manager.
- Reach out to Human Resources or a member of the Legal Department.
- Call the Compliance team
- Send a report using the web reporting system at www.reportlineweb.com/assurant to report illegal or unethical activities in the work place. When you submit a report using the web reporting system, you will be asked to complete the screens of the web report form. You may remain anonymous if you wish.
- Call the Compliance Helpline at 888.427.2542.

When you call the Helpline, you may remain anonymous if you wish.

If you are calling the Helpline from outside the United States, dialing instructions are available at page 4 of the Code.

- Contact the Audit Committee of the Assurant Board of Directors if you wish to raise concerns about accounting, internal controls or auditing matters. You can do so by sending an email to: boardchair@assurant.com. If you wish to remain anonymous, please call the Compliance Helpline or use our web reporting system at www.reportlineweb.com/assurant.

- For employment-related concerns (including harassment or discrimination issues), follow the

reporting procedures for your business, as outlined in the Assurant Employee Handbook.

"The companies that survive longest are the ones that work out what they uniquely can give to the world--not just growth or money but their excellence, their respect for others, or their ability to make people happy. Some call those things a soul." -- *Charles Handy*

Dear Colleagues,

The soul of a company is the key to its longevity. This is especially true for Assurant--we offer products and services that touch people's lives in sickness and health, life and death, and disability and rehabilitation, and our business depends on the trust and confidence we earn from our employees, customers and shareholders. In everything we do, we should remember that people count on us.

Our reputation is based on a promise--to our customers, our shareholders, and ourselves--to act honestly, with integrity and according to the highest legal and ethical standards at all times. That is the most basic responsibility of all Assurant employees, executives, and directors.

It is the responsibility of each of us to uphold these values in everything we say and do in order to continue to cultivate a reputation of which we can be proud. This applies to every member of the Assurant community--including employees, management, members of the Board of Directors, agents, or others.

This Code of Ethics provides guidance regarding the legal and ethical standards that apply to each of us. Together, we will make Assurant stand out among its peers as a company dedicated to excellence in both performance and integrity.

Our reputation starts with you!

Sincerely,

Robert B. Pollock

President and Chief Executive Officer

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Our Personal Commitment

What We Say and Do

At Assurant, everything we say and do must reflect our values and ethical standards. This Code of Ethics provides you with practical guidance to apply these values and ethical standards in your everyday activities, and with resources to call upon when you have questions or concerns.

Our Mission

To be the premier provider of targeted specialized insurance products and related services in North America and selected other markets.

Our Vision

To be a recognized leader in specialty insurance and financial services that provide peace of mind products to our customers. We deliver superior value through innovative and differentiated solutions that advance and secure the lives of our customers.

Our Values

Common Sense, Common Decency, Uncommon Thinking and Uncommon Results--help us accomplish this Mission and achieve our Vision. They extend to our relationships not only with our customers but with one another. Our products and services touch people's lives in sickness and health, life and death, disability and rehabilitation. In everything we do, we remember that people count on us.

Our Ethical Standards

Our ethical standards help ensure that all our decisions and actions are consistent with our values. In the process, we provide outstanding service to our customers, maintain our leadership position, improve employee satisfaction, and provide superior value to our shareholders. The highest standards of ethics and integrity are essential to our success as an organization and as individuals.

What are Assurant's ethical standards?

Our ethical standards require that we:

- Engage in and promote honest and ethical conduct, including the ethical handling of actual or potential conflicts of interest involving personal and professional relationships.

- Comply with applicable laws, rules, regulations and company policies, including the standards in this Code.
- Provide full, fair, accurate, timely and understandable information in reports and documents that we file with the government or issue to the public
- Promptly report any possible violations of ethical standards, using the tools described in this Code.

Wat are the consequences of violating these ethical standards?

Each of us is accountable for adhering to the values, standards and policies in this Code. Acting in any way that does not fit our culture of integrity, responsibility and ethics could damage your personal reputation, as well as the reputation of your team, department or business. When you violate laws, regulations, ethical standards, or company policies, Assurant will take disciplinary action, which could include termination of employment. In some cases, your actions could even result in civil liability or criminal prosecution.

This Code of Ethics is not a contract of employment and does not alter the at-will employment relationship between Assurant and employees of Assurant. This Code is not intended to cover all the specific legal requirements of each country in which Assurant does business. These guidelines apply throughout Assurant's businesses worldwide. Requirements may differ between jurisdictions and, in that regard, it is important that you read these guidelines in conjunction with your business's local policies, which deal more specifically with the legal requirements of the jurisdiction in which you work.

Commitment to Stakeholders

We have a long-standing commitment to operate according to our values, which extends to our customers, employees, business partners, shareholders and communities ("Stakeholders"). Each of these Stakeholders plays a vital role in our success.

Our Customers

We are committed to operating with the highest ethical standards and integrity, and dedicated to dealing honestly with our customers and providing them with quality products and services.

Our Employeeess

We are committed to open, honest communication with our employees. We are devoted to treating our employees fairly and maintaining employment practices based on equal opportunity for all.

Our employees must treat each other with dignity and respect regardless of age, sex, color, race, religion, national origin, marital status, sexual orientation, gender expression, gender identity, pregnancy, veteran status, disability or any other category protected by all applicable federal, state and local laws prohibiting discrimination.

Our Business Partners

We are committed to dealing with our business partners fairly while promoting fair competition. All of our business partners, while dealing with us, should act in accordance with standards and principles consistent with our Assurant Code of Ethics.

Our Shareholders

We are committed to providing long term value to our shareholders. This will be accomplished by observing the highest standards of business practices and ethical conduct in all of our business dealings.

We are distinguished by our leading positions in the specialty insurance business. Although each of our businesses is unique and diverse, they share three things in common: risk management expertise, strong distribution partnerships and complex administrative skills. Each of our businesses leverages these core capabilities to gain a competitive advantage in their selected markets.

Our Communities

We are committed to being responsible corporate citizens by taking an active leadership role in the communities where we do business. We encourage and promote employee volunteerism and corporate philanthropy. We act responsibly toward the environment. We minimize, reuse, and recycle waste at our facilities wherever possible, and dispose of remaining waste responsibly. We strive to improve energy efficiency in all facilities.

Asking Questions and Raising Concerns

If you are unsure of the right course of action, do not guess. Remember--if you have any doubt, reach out to the available resources and ask before you act.

If you become aware of a possible violation of this Code or of any applicable law, regulation or policy, you must report it.

Ask Before Acting

What should I do when faced with a difficult ethical decision or a situation that might be improper?

If you become aware of a possible violation of our ethical standards, or if you are concerned that a course of conduct may be unethical, ask yourself the following questions:

- Might the action in question conflict with any of the standards to which Assurant holds its employees, officers and directors?
- Am I compromising my own ethics in any way?
- How would I or the company feel if the action were reported on the front page of the newspaper?
- Would Assurant lose customers, employees or shareholders--if they knew that some of our employees did this?
- Does the action conflict with our values and commitments to our customers?
- Will my actions have the appearance of impropriety?

If you answer "yes" to any of these questions, or if you are not certain of the answer, you should seek guidance **BEFORE ACTING** by reaching out to your local management or using the reporting tools and reaching out to the resources described under "Asking Questions and Reporting Concerns".

Reporting Illegal or Unethical Behavior

What should I do if I see something or am asked to do something that may violate the law or Assurant's ethical standards?

It is up to each of us to ensure that Assurant operates according to our ethical standards at all times. In addition to making sure that your own actions live up to our ethical and legal commitments, it is your responsibility to report any possible violation of the law or our ethical standards.

Compliance Resources and Reporting Tools

This Code is more than just a description of our standards. It is the centerpiece of a company-wide compliance and ethics program supported by the Board of Directors and senior leaders. The program is led by Assurant's Chief Compliance Officer, Jay Cohen, who is assisted by dedicated compliance resources at the corporate level and in each of our businesses. The Compliance team and the Assurant Legal Department are available to advise and assist you in dealing with laws, regulations, company policies and other compliance issues that affect your work.

Assurant promotes open communication throughout our company to resolve problems, complaints or concerns. We want you to come forward so we have provided several ways for you to ask questions or report concerns:

- First, talk to your manager or another supervisor in your business.
- Reach out to Human Resources or a member of the Legal department.
- Call the Compliance team.
- Send a report using the web reporting system at www.reportlineweb.com/assurant.
- Call the Compliance Helpline.

If you are calling the Helpline from outside the United States or Canada, we have provided the following international toll-free access service, using AT&T direct. Here is how you can use this service:

Make sure you have an outside line (if using a public phone, make sure it can be used to make international calls).

STEP 1: Enter the AT&T direct access number for the country you are calling from (see list below).

STEP 2: When you hear the English-language voice prompt or series of tone prompts, enter the Compliance Helpline toll-free number (DO NOT press "1" or "0" before dialing the telephone number).

STEP 3: The call will be connected to a communication specialist at the Compliance Helpline.

If you do not speak English, or prefer to have an interpreter assist you in speaking with the Communication Specialist, immediately tell the Communication Specialist which language you speak. An interpreter will then join your conversation to assist you.

AT&T Direct Access Numbers as of July 14, 2008

	Telephone #	Access Code
Argentina	888.427.2542	0 800 288 5288

Brazil		800.913.4988	0 800 890 0288
Canada		888.427.2542	
China - South (Shanghai)		800.913.4988	10.811
China - North (Beijing)		800.913.4988	108.888
Denmark		800.913.4988	800.100.10
Germany		800.913.4988	0.800.225.5288
Ireland		800.913.4988	1.800.550.000
Italy		800.913.4988	800.172.444
Mexico	Mexico - New/Por Cobrar	800.913.4988	01.800.288.2872
Puerto Rico		888.427.2542	
Spain		800.913.4988	900.99.0011
United Kingdom	British Telecom	800.913.4988	0.800.89.0011
United Kingdom	C&W	800.913.4988	0.500.89.0011
United Kingdom	NTL	800.913.4988	0.800.013.0011

The Compliance Helpline and the web reporting system are staffed by an independent company and are available 24 hours a day, seven days a week. You can report anonymously if you prefer, although in some cases this may limit our ability to investigate your concerns.

If you want to contact the non-management members of the Board of Directors for any reason, including reporting a concern involving accounting, internal controls or an auditing matter, you may e-mail the Assurant Board of Directors at **boardchair@assurant.com**.

For employment-related concerns (including possible harassment and discrimination issues), follow the reporting procedures for your business, as outlined in your employee handbook.

No Retaliation

Assurant takes all reports of misconduct seriously, and we will promptly and fairly investigate reports made through any of our reporting tools. If you wish to remain anonymous, you may do so by reporting your concern on the Compliance Helpline on a no-name basis.

Even if you identify yourself or report your concern by email, you need not fear retaliation. We will not tolerate any retaliation against anyone who makes a report in "good faith" (meaning that the person reporting has made a genuine effort to provide honest and accurate information even if the information later is proven to be mistaken). Keep in mind that making malicious or purposely false reports violates our Code.

Anyone engaging in retaliation is subject to disciplinary action including possible termination of employment. If you believe that you have been the subject of retaliation, please contact the Assurant Compliance team or use one of the reporting tools.

Real life example

Q. Suppose I am asked by a colleague or supervisor to do something I think is wrong. What should I do?

A. Assurant relies on you to bring your best ethical judgment to bear on the actions you take for us. Therefore, before doing something that you believe is wrong, reach out and ask about the right course of action. The first stop may be to express your concerns to the supervisor or colleague, but you may also make use of the reporting tools and resources described in this section of the Code. Remember, we want you to ASK BEFORE ACTING if you have any concerns about the proper course of action.

Fellow Employees

Respect For Each Other

At Assurant, we are committed to maintaining a supportive work environment and to help employees thrive. Our policies reflect and reinforce our values, and help ensure that each one of us abides by all applicable federal, state and local laws prohibiting discrimination.

How does Assurant promote diversity?

At Assurant, we want to have a diverse workforce of capable employees. We make all employment and personnel decisions based on the basis of merit, competence and qualifications without regard to age, sex, color, race, religion, national origin, marital status, sexual orientation, gender expression, gender identity, pregnancy, veteran status, disability or any other category protected by all applicable federal, state and local laws prohibiting discrimination.

What measures does Assurant take to prevent harassment?

Assurant prohibits harassment of employees, in any form. Harassment is any form of inappropriate conduct toward another person that creates an intimidating, hostile or offensive work environment. Sexual harassment is a form of workplace harassment that involves unwelcome sexual advances, requests for sexual favors, unwelcome physical conduct, or other physical or verbal conduct of a sexual nature.

Harassment will not be tolerated at Assurant, regardless of whether it happens on company premises or at off-hours or off-site business-related functions such as holiday parties or business travel. For further information on this subject, please see the 'Anti-Harassment Policy' section of the Assurant Employee Handbook.

What should I do if someone associated with the company has harassed me?

If you believe that you have been harassed, you should report the matter immediately to your manager or to your business's Human Resources Department. You may also contact the head of Human Resources for Assurant in New York. Managers who receive these complaints must immediately report them to Human Resources. You can also use any of the reporting tools described in this Code.

In all cases, reports will be investigated promptly, in as confidential a manner as possible under the law. Retaliation against an employee for a harassment complaint made in good faith will not be tolerated.

Real life example

Q. I work with and occasionally entertain clients of Assurant. Recently, a client has been making comments about my appearance and making other unwanted advances. His comments make me feel uncomfortable. What can I do?

A. Report the situation to your supervisor or manager, Human Resources, the Compliance team, call the Compliance Helpline, or report your concern at www.reportlineweb.com/assurant. Even though the client is not an employee of Assurant, you should report the situation. Harassment can include actions, whether done by an employee or non-employee, which create a hostile, intimidating or uncomfortable work environment. Assurant takes all reports of harassment seriously and treats each report as discreetly and confidentially as possible.

Real life example

Q. You are uncomfortable with your boss' flirtations but do not want to say anything for fear of losing your job. What should you do?

A. You should speak to someone in your Human Resources department or reach out to the head of Human Resources. Investigations will be conducted as confidentially as possible, consistent with the need to conduct an adequate inquiry, and retaliation for a 'good faith' report will not be allowed.

Health and Safety

Assurant is committed to maintaining the highest level of safety and security for our employees and visitors who conduct business within our offices. You can support this commitment by observing all health and safety rules and laws that apply to your job. It is your responsibility to promptly report accidents, injuries, or occupational illnesses and unsafe practices or conditions to your manager.

Further information and guidance on this subject, can be found in the 'Safety and Security policy' section of the Assurant Employee Handbook.

Responsibilities of Managers

Managers, by virtue of their positions of authority and responsibility, must be ethical role models for other employees. Managers must set an example and demonstrate what it means to act with ethics and integrity. An important part of a manager's responsibility is to exhibit the highest standards of integrity in all dealings with fellow employees, customers, suppliers and the community at large. An equally important responsibility is to obtain team members' commitment--and develop their ability--to make sound ethical judgments. Managers should look for opportunities to routinely communicate and discuss ethical conduct, difficult decisions or other challenging situations with team members. Create an open working environment that encourages team members to come to you, without fear of retaliation, with any questions or reports. When they approach you, make sure you respond promptly. If you are unsure of the answer to a question, refer the question to your Human Resources Department, the Compliance team or utilize any of our reporting tools.

"Things work out best for those who make the best of the way things work out."

Assurant and Its Resources

Conflicts of Interest

Assurant expects all employees, officers and directors to do their best to advance the company's interests and to use objective, unbiased standards when making decisions that affect our company. Business decisions should be made on

the basis of quality, suitability, service, price, qualifications and other appropriate factors, without the influence of personal bias or conflicts of interest.

What is a conflict of interest?

A conflict of interest occurs when your personal or family interests interfere--or appear to interfere--with the interests of the company. Every employee and director must avoid any situation that creates even the appearance of a conflict.

Here are some examples of the types of activities that may create conflicts of interest:

- Outside business interests or employment
- Doing business with, hiring or supervising family members
- Taking personal advantage of corporate opportunities

Real life example

Q. A co-worker has asked you to hire his in-law for a large printing project. You have researched this printer and have found only negative reviews of his work. Should you hire the printer?

A. No. You should express your concerns to the co-worker and suggest alternative approaches. If he persists, you should consult the Compliance team for guidance.

Outside business interests or employment

Sometimes, taking outside employment can create a potential conflict of interest. You may not take another job--full-time or part-time--that interferes with your ability to do your job at Assurant, conduct outside business activities during your Assurant working hours, or use company property, equipment, information or other assets for non-Assurant activities.

If you are thinking about taking an outside job or business interest that could create a conflict of interest, or serving on the board of directors of a company, you must first get your manager's approval and the approval of a Compliance team representative, or call the Compliance Helpline. This rule does not apply to charitable, civic, religious, educational, public, political or social organizations whose activities do not conflict with the interests of Assurant and do not interfere with your ability to do your job at Assurant. If there is any question as to whether a conflict of interest exists, you should discuss it with your manager and the Compliance team.

Real life example

Q. In your free time, you are a member of a soccer team. You have been asked to print 500 fliers for an upcoming game. It would be easier to do this at work, since the office has all the supplies you need. Is this permissible?

A. No. This is a conflict of interest because you would be using company assets -- including supplies and your time at work -- to benefit an outside organization.

Doing business with, hiring or supervising family members

A conflict of interest can occur if someone who is closely related to an Assurant employee--such as a spouse, parent, sibling, child, domestic partner, grandparent, or in-law--has a personal stake in a company that is a supplier, competitor, business partner, customer, or potential customer or supplier of Assurant. If you are involved in or become aware of such a situation, you must notify your manager. You may not attempt to influence Assurant's business relationships for someone who is closely related to you.

A conflict of interest can also arise under certain circumstances if a closely related person is seeking employment at Assurant or is already working here. You must not be involved in any decisions regarding the hiring of a person who is closely related to you. In addition, no one should be placed in a position of direct decision-making authority over a closely related person, such as the direct power to reward, supervise, appoint, remove or discipline the other. The key is disclosure. You should disclose any such relationships to your manager. Your manager will consult with Human Resources or the Legal Department to decide the best course of action.

Remember--it is important to avoid even the appearance of a conflict. If any of these situations has occurred--or may arise--notify your manager immediately.

Taking personal advantage of corporate opportunities

In some cases, through your work and contacts at Assurant, you can become aware of business opportunities that our company may be interested in--such as purchases, investments, new markets, or the development of new products and services. You must notify the CEO or CFO of your business of this opportunity, and refrain from personally pursuing the matter until Assurant has had the chance to evaluate it. At no time can you use any company property, information or other assets for personal gain or to compete with Assurant.

Additional rules for directors, executive officers and other designated individuals

Assurant has additional rules that address loans to directors, executive officers and employees and any related-party transactions, which are certain business transactions between Assurant and designated individuals.

Reporting conflicts of interest

Each year, we ask all Assurant directors, officers, or employees with purchasing authority to complete a conflict of interest questionnaire.

Whether or not you complete this questionnaire, you must promptly report any relationship, transaction or other situation that creates--or has the potential to create--a conflict of interest to your manager or to the Assurant Compliance team using one of the compliance reporting tools.

Business Gifts and Entertainment

Business gifts and entertainment are designed to build good working relationships and goodwill in the marketplace. Under the right circumstances and within limits, these courtesies are an acceptable way to do business. We do not give or receive gifts that could improperly influence--or appear to improperly influence--a business decision.

General Principles and Requirements

In all matters related to gifts or entertainment, we at Assurant exercise good judgment. We understand that under no

circumstance may we or our family members:

- Offer, solicit or accept bribes
- Accept or offer gifts, meals or entertainment, travel or lodging as an improper business inducement or in return for a particular action
- Accept or offer gifts, meals or entertainment, travel or lodging for the purpose of inappropriately influencing good business judgment, impartiality, the fiduciary duties or loyalty of those being entertained in any business dealing or transactions involving Assurant, or any employee of Assurant
- Accept or offer gifts, meals or entertainment, travel or lodging of any value if doing so would reasonably present--or appear to present--a conflict of interest in light of customary industry practices
- Offer or accept travel or lodging of any value unless such offer or acceptance is in accordance with this Code, as outlined below

To assist in upholding these principles, we adhere to the following requirements with regard to any of the gifts or entertainment described in this section of the Code. A business gift or entertainment can only be offered to--or accepted from--any non-Assurant employees, officers and directors if it is:

- Consistent with good business practices and local law
- Has a business purpose
- Is not an improper business inducement
- Would not embarrass Assurant if disclosed publicly
- Is not in poor taste or involving a venue that would reflect poorly on Assurant
- Does not recur frequently enough to suggest an improper motive
- Is reasonable in value and not extravagant or excessive in light of customary and appropriate business practices

You must also adhere to the following additional requirements for these categories of business gifts and entertainment:

Gifts

As employees, officers and directors of Assurant, we may not seek, accept or offer the following gifts:

- Cash or cash equivalents, (except gift certificates or gifts cards of a nominal amount)
- Any items with a value in excess of \$250 (or the equivalent in local currency) in the aggregate during a calendar year given by, or to, any individual

NOTE:

Meals, entertainment, awards, promotional items, or recognition provided to Assurant employees

by Assurant are not considered gifts subject to these conflict of interest restrictions. However, meals or entertainment provided by a third-party, where Assurant employees, officers or directors are not accompanied by the third-party, are to be treated as gifts subject to this restriction.

In rare instances when refusal, reimbursement or return of gifts would cause offense or embarrassment to the giver or would otherwise adversely affect the relationship between Assurant and the giver, we may accept items worth more than \$250 or the equivalent in local currency on behalf of Assurant, and we acknowledge that the gift becomes the property of Assurant. We must advise the giver in an appropriate manner that the items were accepted on behalf of Assurant, and we must report these gifts to the Compliance team within 30 days. There may be limited exceptions where Assurant may give gifts totaling more than \$250 during a calendar year to an individual, **but these exceptions must be approved in advance by Senior Management and the Chief Compliance Officer.**

Real life example

Q. What types of gifts may an Assurant employee accept?

A. In most cases, it is not the type of gift that matters. It is the value of the gift which is at issue. An Assurant employee may not accept a gift worth more than \$250 without the approval of a member of Senior Management and the Chief Compliance Officer. These exceptions should rarely be approved.

Q. Is it unethical to accept money, a vacation, or anything of value, to improperly assist a vendor in securing a contract or other benefit from Assurant?

A. Yes. Any employee who receives bribes or kickbacks will be immediately terminated and reported, as warranted, to the appropriate law enforcement authorities. A kickback or bribe includes any item intended to improperly obtain favorable treatment whether or not the favorable treatment actually results. Under no circumstances may gifts be offered to potential clients or accepted during the bidding or contracting process, unless they are of nominal value.

Meals and Entertainment

As employees, officers and directors of Assurant, we may accept or offer meals and entertainment from business associates (i.e. non-Assurant employees, officers or directors) or prospective business associates as long as the business associates accompany us. We may accept meals or tickets to sporting events, the theater and other recreational events (e.g. golf outings), provided that the purpose is for us to discuss business matters with non-Assurant business associates, and provided that these events comply with the General Principles and Requirements described above.

Travel and Lodging

Any travel or lodging that is offered to or accepted from a third party must adhere to all of the General Principles and Requirements for business gifts and entertainment set forth in this Code.

In addition, it is a generally accepted practice within the industry to host, and attend, business conferences, special presentations or recreational events for the purpose of business discussions and brand-building. By their nature, such events may include the provision of lodging and/or transportation to attendees. If so, Assurant employees may offer or accept travel and lodging for these kinds of events provided that the travel and lodging are reasonable under the

circumstances, meet all of the General Principles and Requirements and also provided that they submit details to the business segment Chief Executive Officer and to the Assurant Compliance Officer in advance of the event for review and approval.

Government Officials

Gifts and entertainment may never be given or offered as a bribe or an incentive to improperly obtain business or referrals. In this regard, we do not make any payments or provide anything of value to government officials or employees to improperly obtain or retain business or improperly gain an advantage in the marketplace. Additional information about our policies and procedures for gifts and entertainment involving foreign government officials is in the section below titled "Anti-corruption Laws, Including the Foreign Corrupt Practices Act".

Charitable Contributions

We play a strong role in supporting the communities in which we do business. Charitable contributions must not be given as a condition of or in order to improperly influence a business decision, in return for a particular action or made for the benefit of any one individual. If a request for a charitable contribution may reasonably present--or appear to present--a conflict of interest in light of customary industry practices, or may be contrary to any of the General Principles and Requirements, such request must be reported to the appropriate senior business leader. Whenever there is any question concerning the appropriateness of a request for a charitable contribution due to the size, frequency or other factors--such as whether such contribution may create a conflict of interest or the appearance of such a conflict--the senior business leader shall review the request with the Chief Compliance Officer before making a contribution.

Use of Assurant's Assets

Assurant's assets must be protected. These include tangible assets such as computers and intangible assets like confidential business information. The following guidelines will assist you in meeting this responsibility:

- Our assets are to be used only by authorized employees, officers and directors.
- You may not take or use the assets of Assurant or of any customer for your own private purposes, or for an improper or illegal purpose. These assets include proprietary and confidential information as these terms are defined in the following section titled "Protecting Information About Assurant, Our Customers and Our Employees."
- You may not remove, destroy or dispose of anything belonging to Assurant without the consent of management.
- When your employment with Assurant ends, you must return all tangible and intangible assets--including electronic records, paper and electronic files, equipment, supplies, proprietary and confidential information, and other materials that belong to Assurant. You may take only your personal belongings.
- Assurant realizes that minor, incidental and infrequent personal use of company assets is sometimes inevitable. Personal use is not acceptable if it significantly depletes the value of a company asset, adds significant costs to the company, interferes with productivity of the employee or places the company at risk of liability. The use of Assurant's computers, the internet, and telephones for personal matters must be kept to a minimum.

"Keep true, never be ashamed of doing right, decide on what you think is right and stick to it." --
George Eliot

Real life example

Q. You spend considerable time each day surfing the web, planning your vacation and sending personal emails. Is this allowed?

A. No, this is not permitted since it involves the use of company assets and your paid work time for non-business purposes. This level of activity is beyond incidental or minor use--which is all that is permitted.

For further information on this subject, see the 'Use of Company Property' policy in the Assurant Employee Handbook.

Protecting Information About Assurant, Our Customers and Our Employees

Assurant employees, officers and directors must respect the confidentiality of all information concerning the company's finances, products, services, systems, business processes, employees, and customers.

In addition, Assurant employees must take particular care of all confidential financial, health and other information that our customers share with us. For further information, please refer to the Assurant Employee Handbook and the following policies: Employee Privacy Policy, Clean Desk Policy, Information Privacy Policy, Privacy of Employee Records Policy, and the Media Requests Policy.

What information is considered confidential and proprietary?

Proprietary information is confidential information about Assurant's products, processes and services. It helps us to differentiate ourselves in the marketplace and to develop and retain a competitive edge. Proprietary information must not be disclosed to anyone outside the company without prior authorization from a senior Assurant official. Such information is for business purposes only and should never be used for personal gain. All proprietary information is confidential, but there is also other confidential information (such as customer information) that may not be proprietary to Assurant. In either case, all proprietary and confidential information must be kept strictly confidential and treated with great care.

Even within Assurant and in the course of your employment responsibilities, all employees, officers and directors must safeguard such information.

Real life example

Q. While surfing the Internet, you came across a chat board that includes postings about our AIZ stock. You would like to post a comment in support of the company. May you do so?

A. No. It is never permissible to post a comment about the Company on a chat room or blog. As an employee, you may have--or be perceived to have--information that is not available to the general public. Also, you may be viewed as speaking on behalf of Assurant and only the Corporate Communications Department and designated officials can do so.

Q. You are attending a seminar and have been asked to make a presentation. In your talk, you are thinking about mentioning the possibility of a new vendor contract that has not yet been publicly announced. Is it permissible to share this information?

A. No. Although sharing information and best practices with other organizations is important and to be encouraged under the right circumstances, we cannot share information about Assurant's business practices, sales and activities if that information is not public.

If you have any questions or doubts about what you may or may not communicate, either within the company or to outsiders, be sure to consult with the appropriate privacy officer, the Legal Department, your manager, or your business's Communications Department.

For further information on this subject, see the Assurant Information Security Management Program, Policies and Procedures.

What are the consequences of the improper disclosure of proprietary or confidential information?

Unauthorized disclosure or misuse of confidential or proprietary information can severely damage our business. Your obligation to protect this information continues even when your employment with Assurant ends. You must never share confidential or proprietary information with any third party without the express permission of Assurant.

Insider Trading

Insider trading is the purchase or sale of a company's securities by someone who has important information that is not available to the public. Insider trading can occur if individuals with such information use it themselves or if they pass it along to others--such as family members or friends--who then purchase or sell the company's securities.

All Assurant employees, officers and directors must be aware of and comply with the rules against insider trading. Here is how these rules apply to you and your work at Assurant:

The laws against insider trading deal with "material" information that is not available to people outside Assurant. Information is "material" if it would influence someone to buy, sell or hold stock in the company to which the information relates. Any information that could reasonably be expected to cause a company's stock price to move up or down is material.

In general, it is illegal for any person with material, non-public information about a company to buy or sell securities (such as shares or stock options) of that company. You may not:

- Buy or sell Assurant stock (or stock options or bonds) if you have material, non-public information
- Provide material non-public information to anyone outside the company who might use it to decide to buy or sell Assurant stock, stock options or bonds
- Disclose material, non-public information to family members or friends

These rules apply to each of us at Assurant--not just executives, managers and directors--and can even apply to the purchase or sale of company stock in your 401 (k) plan and the Employee Stock Purchase Plan.

Real life example

Q. I have some information regarding Assurant's financial performance for the quarter because of my job responsibilities. I would like to make a change to my investment allocation in my retirement fund, but this fund includes stock in Assurant and would result in the purchase of more Assurant stock. Do I need pre-approval to make this change?

A. Yes. If you have material, non-public information about Assurant, U.S. securities laws prohibit you from buying or selling Assurant securities and from making certain elections and transactions under our plans. Directors, Executive Officers and Non-Executive Officers are also subject to additional restrictions on their ability to engage in transactions in Assurant securities. If you are in this situation, you should consult the Assurant Insider Trading Policy or contact Stephen Gauster or Raj Dave of the Assurant Legal Department.

Assurant's Insider Trading Policy provides you with additional guidance including:

- Examples of material information
- The blackout periods and other rules that apply to designated persons called "covered persons"
- The rules that apply to your trading in Assurant stock in a company plan

The Insider Trading Policy can be found on the Compliance intranet site and on your business' intranet site. Before engaging in any trading, please refer to the policy for additional instructions and details about the rules against insider trading.

Real life example

Q. You learned about Assurant's potential acquisition of another company. This information is not available to the public. You are thinking about recommending to your brother that he purchase stock in that other company in advance of the acquisition. Is this allowed?

A. No. This would involve illegal "tipping" of material non-public information to another, even though it involves the stock of a company besides Assurant.

Accurate Books, Records and Public Disclosures

We make business decisions each day based on information recorded by our employees at every level of the organization. Our recorded information is used to advise investors about our financial results, to make required legal filings and support new products and services. Incomplete or inaccurate information can lead to poor decisions and to serious problems for Assurant and the individuals involved. For example, improper recording or reporting of revenues and expenses can lead to misrepresentation of our business and finances, which can be illegal.

Every one of us, regardless of our position at Assurant, must make sure the information we report and record about our work here is accurate and complete. This includes information we submit on expense reports, sales data, production

data, contracts, monthly and quarterly reports and other corporate records. These rules apply no matter where we work, anywhere around the world, and in every unit of the company.

If you have questions or concerns about any aspect of our business records, financial reports or public disclosures, you should discuss them with your manager, our finance and accounting personnel, the Legal Department or the Compliance team. If you have reason to believe that information is being deliberately misreported or concealed, you should call the Compliance Helpline, talk to one of our compliance or Legal Department personnel, or email the Assurant Board of Directors at boardchair@assurant.com.

"The greater the loyalty of a group toward the group, the greater is the motivation among the members to achieve the goals of the group, and the greater the probability that the group will achieve its goals." -- *Rensis Likert*

Real life example

Q. It is the last week of the quarter. You and your manager want to make sure you meet your sales targets for the quarter, so you would like to record a sale that will not be finalized until next week. You are sure that this deal will close, so what is the harm in recording it now?

A. The harm is that our records for this quarter will not be accurate. Costs and revenues, including new sales, must be recorded in the period in which they are incurred or earned. This sale is not earned until it is finalized and may not be recorded until then.

Records and Information Management

Assurant is responsible for ensuring that its business records, in any medium, including hard copy and electronic records, are created, managed, and disposed of properly. An effective, efficient records and information management program allows Assurant to meet its business needs as well as comply with all legal and regulatory obligations. Assurant employees must familiarize themselves with and abide by the Assurant Records and Information Management Policy and procedures. For further information on this subject, see the Assurant Records and Information Management Policy intranet site.

Political Activity

Assurant encourages employees to be involved in civic affairs and the political process. This includes making personal contributions to civic organizations, political candidates and political parties.

However, employees are prohibited from contributing Assurant's funds, property, services or employee time to any political party, committee or candidate--for any office at any level of government--without prior approval by the Chief Compliance Officer. Prohibitions include:

- Use of company email or mailing lists to promote a candidate
- Use of company time to work or volunteer for a candidate
- Pressuring any colleague, supplier, customer, vendor or partner to make any political contribution or support any candidates

- Asking subordinates to purchase tickets to political fund-raisers or otherwise contribute to candidates or campaigns

To avoid even the appearance of a conflict of interest, no Assurant employee may hold an elected, appointed or advisory position in any federal, state or local government without prior approval by the Chief Compliance Officer.

The Marketplace

Ethical Business Practices

At Assurant, our mission is to "be the premier provider of targeted specialized insurance products and related services" in the markets in which we operate.

Behaving ethically is not only the right thing to do, it is fundamental for business success and essential for us to achieve our mission. Our reputation depends on the honest and ethical behavior of each of us in every transaction and business dealing, every day.

Here are some guidelines to apply this in practice:

- You should make decisions that serve the best interests of our customers.
- You should never deceive, defraud or misrepresent the company or its products and services.
- You should never mislead, manipulate or take unfair advantage of a customer, member, provider or supplier, or help anyone else do any of these things.
- You should never misrepresent facts, contractual terms or company policies to a customer, member, provider, supplier or regulator. If you do so, even inadvertently, you must correct the misrepresentation as soon as possible after consulting your manager and the Legal Department.
- You should not violate any law or regulations, including unfair trade or insurance practice laws.

Business and Trade Practices

Assurant conducts business in a highly regulated environment. Each business unit plays a role in assuring that we meet our legal and regulatory obligations as well as the commitments we make to our customers. You must make yourself aware of and abide by the rules that apply to your job responsibilities.

Business Agreements

Assurant prohibits employees from entering into any oral agreement or oral contract for a transaction or business relationship involving the exchange of money for goods or services between Assurant or any of its businesses and a third party. Additionally, any business agreement with an agent, broker, representative, consultant or contractor must be in writing and must clearly state the services to be performed, the basis for earning the commission or fee, and the rate or fee.

Real life example

Q. A reinsurer has suggested that we have a "handshake agreement" under which reinsurance capacity will

continue to be available to us as long as the reinsurer's experience on our account has been profitable. Is this ok?

A. No. All agreements must be in writing. This does not preclude authorized officers, employees or agents from making oral agreements in the normal course of negotiations if such agreements are promptly followed by preparation and execution of appropriate documentation.

"Moral principle is the foundation of law."

Doing Business with the Government

If you work in a business unit contracting with the U.S. or any state government or agency, you must comply with the applicable statutory, regulatory and program requirements related to the contract.

All Assurant employees working on government contracts have a responsibility to report any known or suspected violations of applicable statutory, regulatory or program requirements. There are strict rules about what may be offered to government employees, especially if the government employee is a contract officer for a contract we have or are seeking. In that case very little, if anything, can be offered to the person. In some cases, you may not even be able to offer beverages or food during a meeting.

If you are unsure of the requirements related to a government contract, ask your manager.

Sales and Marketing

One of Assurant's Ethical Standards is to provide outstanding customer service. We must treat customers with honesty, integrity, fairness and respect at all times. We must not create misleading impressions, omit important facts or make false claims about our competitor's offerings. Assurant is committed to complying with all "truth in advertising" laws.

Antitrust and Competition

We compete fairly, in accordance with our values, and in compliance with all applicable antitrust and competition laws in every jurisdiction in which we operate. These laws are very complex. They are intended to provide customers with a variety of products at competitive prices unrestricted by artificial constraints such as price fixing, illegal cartels, boycotts, and tie-ins. Violations of these laws can result in significant penalties for Assurant and the individuals involved, as well as loss of reputation and standing in the marketplace.

We have developed a comprehensive Antitrust Policy for all of our businesses, to help you ensure that the conduct of our organization is in full compliance with these laws at all times. You can find this policy on the Compliance intranet site.

The Antitrust Policy is a general guide to compliance with the antitrust and competition laws. The Legal Department should always be consulted before you engage in any business practice that could have antitrust implications. In general, these laws prohibit monopolies, price-fixing, bid-rigging and other practices that limit trade and fair competition.

It is illegal under these laws to enter into any agreement with a competitor that unreasonably restricts competition. Illegal agreements do not have to be formal or written; they can be as simple as an oral understanding among the parties.

Trade associations and other circumstances in which you come into contact with representatives of our competitors can pose particular concerns under the antitrust and competition laws. During such activities, including all informal and social activities, it is important that you refrain from discussing or exchanging any information with competitors regarding prices, discounts, products and services, markets, margins, terms of coverage, customers, providers, reimbursement levels and methodologies, or any similar information. Even casual remarks can raise significant concerns.

If you perceive that a possible antitrust violation is occurring--or is about to occur--you should immediately leave the meeting. All actual or potential violations must be immediately reported to the Legal Department.

Real life example

Q. At a trade association meeting, you meet with employees of competing companies for drinks after dinner. The conversation turned to the prices Assurant charges certain customers in some of our markets. This did not seem right to you, but you were not sure what to do and just remained there without speaking. Did you do the right thing?

A. No--employees must make clear to the others in the conversation that they cannot and will not participate or even be present for conversation about prices, products, markets or similar issues. If such talks continue, you must leave. You should then report the matter to the Legal Department as soon as possible.

Anti-corruption Laws, Including the Foreign Corrupt Practices Act

In all of the markets around the world in which we operate, Assurant will not offer or pay bribes to government officials, business partners or others to obtain or retain business, secure an advantage, or for any other reason.

The Foreign Corrupt Practices Act

Assurant employees working outside the United States--or supervising those who do--must be aware that payments of bribes or anything else of value to foreign government officials can violate the Foreign Corrupt Practices Act (FCPA), a U.S. federal criminal law. These actions may violate local criminal laws, as well.

The FCPA has two parts: 1) anti-bribery provisions and 2) books and records requirements. Each part has a broad application to our business practices.

The anti-bribery requirements of the law prohibit the payment of "anything of value" by company employees or agents to a foreign government official to improperly obtain or retain business, or gain an unfair advantage in the marketplace. "Anything of value" can include direct cash payments, political or charitable contributions, jobs or other benefits to family members and even lavish gifts, travel or entertainment. "Foreign government officials" include officials at all levels of government, political party officials and also private employees of government-owned or government-controlled business such as hospitals.

We are responsible for payments made by Assurant officers and employees--as well as anything of value provided to foreign government officials by those acting on our behalf including agents, contractors, consultants, brokers and business partners. This means that Assurant employees must exercise great care in hiring consultants, agents, brokers or other third parties that deal with foreign government officials on our behalf. Assurant employees must also exercise caution in entertaining or providing gifts to foreign government officials, and in arranging travel for these officials to

company business sites.

The books-and-records provisions of the FCPA require that we keep detailed and accurate records about ALL of our business transactions around the world, including contracts with third parties and payments to foreign government officials. Reports about every transaction and use of company assets--whether or not related to foreign government officials and even including all transactions taking place in the United States--must be accurate, complete and in "reasonable detail." Any payments to foreign agents or officials must be properly identified and accurately recorded.

To promote compliance with the FCPA, and similar anti-bribery laws, Assurant has an Anti-Corruption Policy. This policy provides additional information on the provisions of the FCPA; guidance on the hiring of third parties including "red flags" to look for in evaluating and selecting them; anti-corruption contract language to be included in contracts with these third parties; limits, required approvals and reporting requirements for gifts, travel and entertainment involving foreign government officials; and FCPA due diligence requirements for overseas mergers and acquisitions.

This policy and the accompanying guidance can be found on the Compliance intranet site. Officials and employees involved in the conduct and supervision of our overseas business activities must familiarize themselves with this policy and guidance, and should talk to the Legal Department or Compliance team about any questions or concerns.

Intellectual Property of Third-Parties

It is Assurant's policy not to infringe upon the intellectual property rights of others. Whether preparing advertising or promotional materials using the name or printed materials of another company, or operating a software program on an Assurant personal computer, you must ensure that the trademarks, copyrighted materials and other intellectual property of others are used properly and only with permission, and you can only copy documents and materials with permission or when those materials are not copyrighted. If you need guidance in this area, please contact the Legal Department.

Real life example

Q. You work overseas and have become friendly with some foreign government officials. As a thank you for being so hospitable, you want to give a watch to one of these officials. He has never promised to do anything in return. Can I do this?

A. You must follow the reporting and approval procedure for providing gifts to foreign government officials BEFORE making this gift. This will assure that we remain in compliance with the FCPA and any relevant local laws. This procedure can be found in the Anti-corruption Policy on the Compliance intranet site.

Audits and Investigations

From time to time, Assurant will be subject to audits, investigations and examinations by regulators. Also, audits are routinely conducted by Risk and Advisory Services and by our external auditors, and internal investigations can be conducted by the Legal, Compliance, Risk Advisory Services (RAS), or Human Resources Department. You must cooperate fully and honestly with these inquiries, and you may not do anything to mislead or improperly influence the review. If you receive a request for information or notice of an investigation from a government agency, you must immediately notify the Legal Department.

Waivers of the Code

Waivers or exceptions to the Code will be granted only under exceptional circumstances. All waivers or exceptions require prior, written approval by your manager and the Chief Compliance Officer.

Only the Assurant Board of Directors may grant waivers of compliance with the Code to the CEO, CFO, principal accounting officer, controller or persons performing similar functions. Any such waivers that are granted will be disclosed promptly and in accordance with all applicable laws and regulations, including those of the Securities and Exchange Commission and the New York Stock Exchange.

Supplemental Standards for Chief Executive Officers and other Senior Financial Officers of Assurant

In addition to complying with all policies included in the Assurant Code of Ethics, the chief executive officer, principal financial officer and controller or principal accounting officer, or persons performing similar functions (the "Financial Officers") of Assurant, Inc., Union Security Life Insurance Company of New York, Union Security Insurance Company, Assurant Employee Benefits, Assurant Solutions, Assurant Specialty Property, and Assurant Health must comply with the following supplemental ethical standards:

Integrity and Accuracy of Public Disclosures

The Financial Officers shall take all reasonable steps to provide full, fair, accurate, timely and understandable disclosures in the reports and documents that Assurant, Inc., Union Security Life Insurance Company of New York and Union Security Insurance Company file with or submit to the Securities and Exchange Commission and in other public communications made by these businesses. In the event that a Financial Officer learns that any such report, document or communication does not meet this standard and the deviation is material, then such officer shall review and investigate such deviation, advise the Board of Directors of Assurant, Inc. or the Audit Committee of the Board of Directors regarding the deviation and, where necessary, revise the relevant report, document or communication.

Our Personal Commitment

Once a year, we will ask each Assurant employee, officer and director to record an individual commitment to compliance with this Code. You will be asked to certify your understanding of and compliance with the Code.

As you work on behalf of Assurant throughout the year, we urge you to discuss any questions and concerns before you take an action that may be inconsistent with our values, ethical standards, this Code, and other Assurant policies and procedures. You are always free to discuss our values and ethical standards with management at all levels of the organization, and to contact the Compliance team at any time.

Your actions make a difference--it is due to the honesty and integrity of our employees that give Assurant its excellent reputation for having the highest ethical standards and business practices. We thank each of you for living the Assurant values and continuing our commitment to excellence.

A Final Thought

Our reputation starts with you. Strong company performance has its roots in the ethical behavior of every member of the Assurant community; it is up to each and every one of us to ensure that Assurant operates according to our ethical standards at all times. If you ever have any doubt about what the right decision is or are concerned that a possible violation is occurring, immediately ask for help. Asking for help is a leadership strength.

If you ever feel pressured to act in a way that conflicts with the Code, talk with your manager, Human Resources, the Compliance team or report your concern through any of our reporting tools. You need not fear retaliation. We will not tolerate any retaliation against anyone who makes a report in good faith.

Thank you for your personal commitment to maintain and build our reputation.

"Motivation is what gets you started. Habit is what keeps you going." -- *Jim Rohn*

Assurant
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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice 14.syn

AUTHOR: John F. Olson Ari B. Lanin

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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

*2-14 Corporate Governance: Law and Practice § 14.01***AUTHOR:** John F. Olson Ari B. Lanin**§ 14.01 The CEO, the CFO and other Members of Senior Management****[1] The Role of Senior Management**

The state laws governing the organization and governance of corporations in the United States almost invariably provide that a corporation's business is to be managed by, or under the direction of, the company's board of directors.ⁿ¹ In practice, however, boards of directors do not manage their company's business and affairs on a day-to-day basis. Instead, day to day business operations are primarily run by the company's senior management team--a group that generally consists of the company's chief executive officer, chief financial officer and chief operating officer, among others.ⁿ² While public companies traditionally have vested responsibility in the CEO as leader of management rather than diffusing high-level responsibility among several individuals, with the passage of the Sarbanes-Oxley Act of 2002 and the continuing adoption of strengthened listing standards by self-regulatory organizations, these leadership responsibilities increasingly are shared among the CEO and the senior management team.ⁿ³ Though the board of directors reviews and approves general strategic objectives, it is this senior management team that is responsible for their development and implementation. Under the oversight and with the approval of the board, senior management, led by the CEO, also executes the company's plans, develops the budget and financial goals, assembles the management team, identifies and manages the risks inherent in operations and supervises the systems that allow for the production of financial statements that present the company's financial condition and give investors an understanding of the company's business, financial soundness and risks.ⁿ⁴ As such, it is the senior management team, led by the CEO and CFO, that drives the company's business performance. Given this centralized leadership structure, the senior management team should be vigilant in setting a strong, positive "tone at the top" that will establish and maintain a corporate culture of integrity, ethical behavior and legal compliance.ⁿ⁵

Because concentration of day-to-day control in senior management may, in certain situations, give rise to conflicts of interest and other problems, senior executives should endeavor to involve themselves personally in the promotion of ethical company values and responsible behavior, be faithful to the interests of investors and act with ability and integrity.ⁿ⁶ Senior executives should be committed to making long term shareholder value their top priority and remain cognizant of activities that could impair their company's reputational capital.ⁿ⁷ Senior management also has primary responsibility to put into place and review and evaluate periodically suitable codes of conduct and ethics applicable to

all employees, to respond swiftly to ethical violations with appropriate disciplinary action and to revise codes of conduct and ethics from time to time as appropriate to comply with new laws and to accommodate any changes in the company's structure.ⁿ⁸

To enhance corporate governance, senior executives should consider establishing a system that rewards employees for achieving articulated governance goals, while recognizing that good governance is far more than a "check the box" list of minimum board and management policies and duties.ⁿ⁹ A successful governance system involves principled goal setting, effective decision making and diligent monitoring of performance and compliance by the management team. Only through a "vibrant and responsive structure," can the senior management team effectively respond to changing circumstances within a framework of solid corporate values, so as to provide long-term value to shareholders.ⁿ¹⁰

In consultation with the board of directors and the audit committee, CEOs, CFOs and other senior management members must also be mindful of the high level of legal and investor scrutiny of controls and risk management. Thus, in addition to setting a strong ethical "tone at the top" and maintaining and enforcing effective codes of conduct, management teams must assess, establish and maintain carefully considered company programs in the following areas, among others:

- internal controls to cause assets to be adequately safeguarded and to help assure the collection and evaluation within the corporation and dissemination to shareholders and others of accurate financial information;
- disclosure controls and procedures designed to ensure accurate reporting up within the corporation and dissemination, as appropriate, to shareholders and others of material information; and
- company-wide integrated risk identification and management.ⁿ¹¹

CEOs, CFOs and other senior management members should also consider how to best work with their boards of directors and compensation committees to promote and effect sound compensation systems that reduce incentives toward excessive risk taking.ⁿ¹²

Effective operation of these programs will enable senior management, the board of directors and the audit committee to understand better the risks taken in the course of carrying out the business and the company's existing compliance and corporate governance issues.ⁿ¹³ It will also help to provide early warning of, and the opportunity to manage effectively, potential problems, and enable the CEO, CFO and the outside auditors to provide required certifications and disclosures.ⁿ¹⁴

[2] The Chief Executive Officer

Within the senior management team, public corporations in the United States "have traditionally vested responsibility in the chief executive officer as the leader of management, rather than diffusing high level responsibility among several individuals."ⁿ¹⁵ The selection, compensation and evaluation of a highly qualified and ethical CEO may thus be the single most important function of a company's board of directors.ⁿ¹⁶ The requirements for an effective CEO vary depending upon the nature, size and type of his or her business and industry. For example, in larger, public corporations, the CEO's responsibilities may focus primarily on setting the overall direction and policy of the company, while in smaller organizations, the CEO also acts as more of a day-to-day manager. Regardless of the type of entity, with the support of the senior management team, the CEO implements the company's strategy and business plan and identifies and enhances the company's management team. The CEO should also have an effective and ongoing relationship with the board of directors (and its chair or lead or presiding director) and a deep, working knowledge of the company's industry and managerial experience that suits the requirements of his or her organization, as well as a willingness to lead his or her company and adapt to the changing needs of the marketplace.

The CEO is also the most important figure in setting an appropriate "tone at the top." As former Federal Reserve Board Chairman Alan Greenspan said, "the state of corporate governance to a large extent reflects the character of the CEO."¹⁷ Because of the CEO's position of power and control, operating the company in an ethical and effective manner is a primary responsibility.¹⁸ He or she should take definitive steps to help all employees understand and abide by the corporation's rules of ethical conduct and make compliance with the law and the company's own standards an explicit part of each employee's annual review as "prevention is the best cure for malfeasance."¹⁹ And of course, the CEO should not place personal interests, whether financial or non-financial, before those of the company and its shareholders.²⁰

With respect to compliance and reporting obligations, the CEO should be committed to maintaining adequate controls to produce accurate financial reports and other material information effectively for the investing public, while complying with the array of applicable securities laws and regulations. This entails effective coordination with the company's board of directors and audit committee, general counsel, CFO, internal audit team and outside auditors.

As further discussed in § 14.02 below, the Sarbanes-Oxley Act, the rules thereunder adopted by the SEC and the related rules of self-regulatory organizations (SROs) have made these and other requirements of the CEO express. CEOs and CFOs are specifically obligated to:

- provide the certification required under Section 302 of the Sarbanes-Oxley Act and accordingly establish, maintain and evaluate the effectiveness of disclosure controls and procedures and internal control over financial reporting;²¹ and
- provide the certification required by Section 906 of the Sarbanes-Oxley Act.²²

Additionally, pursuant to the NYSE Listed Company Manual rules, CEOs of companies with securities listed on the NYSE must annually certify to the NYSE that they are not aware of any violation by their company of NYSE corporate governance listing standards.²³

[3] The Chief Financial Officer

With the aid of the other members of senior management, the internal audit team, the external auditor and the audit committee, the chief financial officer is responsible for the company's publicly filed financial statements and the creation, implementation and evaluation of company financial plans. It is the CFO's job to direct the production of high-quality financial reports that present objective, consistent and reasonably understandable statements of the company's financial results and condition and to oversee internal controls, record keeping, tax reporting and cash and investment management.²⁴ To this end, an effective CFO should have knowledge and experience in the implementation of internal controls, accounting rules, operating requirements, bookkeeping and budgeting.

The Sarbanes-Oxley Act and the SEC's related rules focused public and regulatory scrutiny on financial reporting and disclosure, substantially transforming the role and responsibilities of the CFO.²⁵ The CFO, like the CEO, now is legally obligated to participate in the establishment, maintenance and evaluation of his or her company's disclosure controls and procedures and internal control over financial reporting, to assess and report on the effectiveness of internal control over financial reporting, and to certify as to these controls and procedures and the information presented in the company's periodic reports.²⁶

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General

OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley ActSecurities LawSelf-Regulating EntitiesNational Securities ExchangesNew York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Del. Code Ann. tit. 8, § 141(a)* (2009); Model Bus. Corp. Act § 8.01(b) (2009). *See also* Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, *59 Bus. Law. 145* (2003).

(n2)Footnote 2. *See* Business Roundtable, Principles of Corporate Governance 1, 10-11 (Nov. 2005) and reproduced in Appendix A to this treatise.

(n3)Footnote 3. *See* Business Roundtable, Principles of Corporate Governance 10-11 (Nov. 2005) (emphasizing that responsibilities are shared by the CEO and senior management).

(n4)Footnote 4. *See* Business Roundtable, Principles of Corporate Governance 10 (Nov. 2005).

(n5)Footnote 5. *See* Business Roundtable, Principles of Corporate Governance (Nov. 2005). In its Principles of Corporate Governance, a comprehensive discussion of recommended corporate governance practices, the Business Roundtable, an association of CEOs of leading corporations, continues to suggest that the "tone at the top" establishes and communicates a culture of integrity and legal compliance for personnel throughout the corporation. The United States General Accounting Office (GAO), in its Corporate Governance, Transparency and Accountability Forum took a similar position, explaining that the integrity and competency of top management, or the "tone at the top," is critical to an entity's ultimate success and to restoring public trust and confidence in the market that can be sustained over the long-term. *See* General Accounting Office, Highlights of GAO's Corporate Governance, Transparency and Accountability Forum, GAO-02-494SP (Mar. 2002); *see also* General Accounting Office, Challenges to Restore Public Confidence in U.S. Corporate Governance and Accountability Systems, GAO-03-419SP (Jan. 2003). In the days leading to the enactment of the Sarbanes-Oxley Act of 2002, President George W. Bush also expressed that "reform should begin with accountability, and reform should start at the top. The chief executive officer has a daily duty to oversee the entire enterprise, the entire firm, and therefore, bears a unique responsibility for serving shareholder interests." George W. Bush, *Remarks By the President at Malcom Baldrige National Quality Award Ceremony* (Mar. 11, 2002, Monday). *See also* Committee of Sponsoring Organizations of the Treadway Commission, Internal Control--Integrated Framework (1992).

(n6)Footnote 6. *See* ABA Task Force on Corp. Responsibility, Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003). Mr. Olson, one of the co-authors of this chapter, was a member of the ABA Task Force. *See also* Committee of Sponsoring Organizations of the Treadway Commission, Internal Control--Integrated Framework (1992). The "Committee of Sponsoring Organizations" ("COSO") was formed in 1985 as a voluntary private-sector organization dedicated to improving the quality of financial reporting through effective internal controls, corporate governance and business ethics. It is sponsored by the American Institute of Certified Public Accountants ("AICPA"), the Institute of Internal Auditors ("IIA"), Financial Executives International ("FEI"), Institute of Management Accountants ("IMA") and American Accounting Association ("AAA"). In 1992 COSO produced a report entitled "Internal Control--Integrated Framework". *See also* Harvey L. Pitt, *Testimony Concerning The Corporate and Auditing Accountability, Responsibility, and Transparency Act*, U.S. Securities and Exchange Commission (Mar. 20, 2002) at www.sec.gov/news/testimony/032002tshlp.htm. COSO and its "Internal Control--Integrated Framework" are discussed in §14.02[d][i] below.

(n7)Footnote 7. *See Personal Accountability Is Key To Sarbanes-Oxley Compliance, Leading Risk Consulting Firm Identifies Top Seven Questions For Executives and Boards*, PR Newswire Oct. 2, 2002. It has been suggested that a strengthened stance on ethics by the CEO and other senior management can not only help companies minimize the

costs of misconduct, but can enhance their reputations and help to preserve the public's trust in business. *See* Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control--Integrated Framework* 6 (1992).

(n8)Footnote 8. *See Personal Accountability Is Key To Sarbanes-Oxley Compliance; Leading Risk Consulting Firm Identifies Top Seven Questions For Executives and Boards*, PR Newswire, Oct. 2, 2002. Codes of corporate conduct and ethics are discussed in Chapter 13 above.

(n9)Footnote 9. *See* Business Roundtable, *Principles of Corporate Governance* 5 (Nov. 2005).

(n10)Footnote 10. *See* Business Roundtable, *Principles of Corporate Governance* 6 (Nov. 2005).

(n11)Footnote 11. *See* Robert E. Bostrom, *Corporate Governance, Risk Management and Compliance After Sarbanes-Oxley: Some Thoughts On Best Practices and the Role of General Counsel*, The Metropolitan Corporate Counsel, Nov. 2002, at 14.

(n12)Footnote 12. The financial crisis that began in 2007 has highlighted the way in which compensation programs can impact executive risk-taking. *See* Financial Stability Forum, *FSF Principles for Sound Compensation Practices* 1 (April 2009). "Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialized." *See also* Mary L. Schapiro, *Address to the Council of Institutional Investors* (April 6, 2009).

(n13)Footnote 13. *See* Robert E. Bostrom, *Corporate Governance, Risk Management and Compliance After Sarbanes-Oxley: Some Thoughts On Best Practices and the Role of General Counsel - Part II*, The Metropolitan Corporate Counsel, Nov. 2002, at 14.

(n14)Footnote 14. *See* discussion in § 14.02 and § 14.08[5] below.

(n15)Footnote 15. Business Roundtable, *Principles of Corporate Governance* 7 (May 2002). Former Federal Reserve Board Chairman Alan Greenspan explained, "it has increasingly fallen to corporate officers, especially the chief executive officer, to guide the business, hopefully in what he or she perceives to be in the best interests of the shareholders." Alan Greenspan, *Remarks at the Stern School of Business of New York University* (Mar. 26, 2002). *See also* Business Roundtable, *Principles of Corporate Governance* 12 (Nov. 2005).

(n16)Footnote 16. *See* Business Roundtable, *Principles of Corporate Governance* 7 (Nov. 2005).

(n17)Footnote 17. Alan Greenspan, *My Say: Improving Corporate Governance*, The Edge Malaysia, July 22, 2002, at 1. The recent negative attention directed toward the Big Three automakers as a result of the actions of their CEOs illustrates how the CEO sets the "tone at the top". *See* Josh Levs, *Big Three auto CEOs flew private jets to ask for taxpayer money*, CNN.com (Nov. 19, 2008), at <http://www.cnn.com/2008/US/11/19/autos.ceo.jets/>.

(n18)Footnote 18. Business Roundtable, *Principles of Corporate Governance* 2 (Nov. 2005).

(n19)Footnote 19. The Conference Board, *Commission on Public Trust and Private Enterprise, Findings and Recommendations* 24 (2003). Compliance and ethics programs are discussed in §14.06 below.

(n20)Footnote 20. One area of potential conflict that is not always recognized involves interlocking directorships. A CEO should consider whether sitting on the board of his or her director's company is in the best interest of the CEO's company. Such interlocking arrangements can, in some circumstances, give the appearance of cronyism, or worse, collusion--both of which may be damaging to the CEO's company. *See* Joe D. Goodwin, *10 Guidelines Board Members Should Follow To Be Effective In Their Duty To Shareholders*, Business Wire (June 19, 2002), at 1. Note also that

Section 8 of the Clayton Act prohibits an individual from simultaneously serving as an officer or director of competing corporations that each have combined capital, surplus, and undivided profits in excess of \$26,161,000. *See 15 U.S.C. § 19(a)(1)*; 71 Fed. Reg. 1688-01 (Jan. 13, 2009). CEOs should also limit their service on other boards to a number which does not conflict with applicable self-regulatory organization (SRO) listing standards. For example, the commentary to Section 303A.07 of the NYSE Listed Company Manual provides, "if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve to three or less, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC." *See NYSE Listed Company Manual § 303A.07(a) Commentary.*

(n21)Footnote 21. *See* discussion in § 14.02[2] below.

(n22)Footnote 22. As discussed in § 14.02[3] below.

(n23)Footnote 23. *See* NYSE Listed Company Manual § 303A.12, discussed further in § 14.02[4] below. Nasdaq also has a corporate governance certification requirement, though it may be signed by any duly authorized officer. The Nasdaq corporate governance certification is also discussed further in § 14.02[4] below.

(n24)Footnote 24. *See* Zabihollah Rezaee, *High-Quality Financial Reporting: The Six-Legged Stool*, Institute of Management Accountants, Feb. 2003, at 3.

(n25)Footnote 25. *See generally* Lucinda Schmidt, *Business As Usual*, Business Review Weekly, Apr. 10, 2003 (Australia); Colleen Cunningham, *Doing the Right Thing, Even When It's Costly*, Compliance Week, April 2009 ("The role of the CFO has become one of the riskiest jobs in America.").

(n26)Footnote 26. Internal control over financial reporting and disclosure controls and procedures are discussed in §14.02[2] below.



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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.02

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§ 14.02 CEO and CFO Certifications, Disclosure Controls and Procedures and Internal Control Over Financial Reporting

[1] Overview

Pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act, chief executive officers and chief financial officers (or persons performing similar functions) of issuers are required to certify as to the accuracy of the periodic reports (including financial information) with which such certifications are filed, as to the CEO's and CFO's responsibilities relating to disclosure controls and procedures and internal control over financial reporting and as to whether fraud involving key employees has been communicated to the company's auditors and audit committee.ⁿ¹ By obligating CEOs and CFOs to review periodic reports, make these certifications and establish, maintain and evaluate their companies' disclosure controls and procedures and internal control over financial reporting,ⁿ² the SEC's rules under Sections 302 and 906 of the Sarbanes-Oxley Act in effect, require CEOs, CFOs and their companies to adhere to minimum corporate governance standards.ⁿ³

Specifically, Section 906, a criminal provision, requires CEOs and CFOs to certify that periodic reports filed with the SEC containing financial statements "fully compl[y] with the requirements of section 13(a) or 15(d) of the [1934 Act] and that information contained in [such] periodic report[s] fairly presents, in all material respects, the financial condition and results of operations of the issuer."ⁿ⁴ Section 302 and the related rules adopted by the SEC require each of the CEO and CFO to certify as to their review of the periodic report to which the certification is attached and as to the establishment, maintenance and evaluation of disclosure controls and procedures and internal control over financial reporting.

In addition to requiring CEOs and CFOs to make the statements required in the Section 302 certifications, and in order to enable CEOs and CFOs to make such statements, the SEC's rules require issuers to, with respect to disclosure controls and procedures:

- "maintain disclosure controls and procedures;"ⁿ⁵ and

- have management "evaluate, with the participation of [the CEO and CFO], the effectiveness ... of the issuer's disclosure controls and procedures, as of the end of each fiscal quarter."⁶

With respect to internal control over financial reporting, the SEC's rules require issuers to:

- "maintain ... internal control over financial reporting;"⁷ and
- have management "evaluate, with the participation of [the CEO and CFO], the effectiveness of the issuer's internal control over financial reporting ... [and] any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters ... that has materially affected, or is reasonably likely to affect materially the issuer's internal control over financial reporting."⁸

Further, issuers must include in each quarterly and annual report filed with the SEC, the following *complementary* disclosure relating to disclosure controls and procedures and internal control over financial reporting:⁹

- the CEO's and CFO's conclusions regarding the effectiveness of disclosure controls and procedures as of the end of the period covered by the report;¹⁰
- whether there have been any changes in internal control over financial reporting that occurred during the prior fiscal quarter that have materially affected, or are reasonably likely to affect materially internal control over financial reporting;¹¹

Additionally, pursuant to Sections 302 and 404 of the Sarbanes-Oxley Act and the rules adopted by the SEC thereunder, issuers must include in their annual reports a report of management and a related report of the outside auditor on internal control over financial reporting.¹²

These requirements have significantly increased management's (in particular, the CEO's and CFO's) responsibility for, and involvement with, the procedures through which companies implement controls and disclose information to the public. Although the CEO and CFO may rely on others involved in the disclosure process to provide backup certifications, collect and analyze the information required for SEC reports, and draft the reports that are filed with the SEC,¹³ they should be directly involved in monitoring the processes that generate the information and reports, and they must review and have a basis to certify before filing.¹⁴

[2] The Section 302 Certification, Disclosure Controls and Procedures, and Internal Control Over Financial Reporting

[a] The Section 302 Certification

The rules adopted by the SEC pursuant to Section 302 of the Sarbanes-Oxley Act require the CEO and CFO to certify to the following in each quarterly and annual report (including transition reports) filed or submitted to the SEC under Section 13(a) or 15(d) of the 1934 Act:¹⁵

- he or she has reviewed the report;
- based on his or her knowledge the report accompanying the certification "does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by [the] report";¹⁶
- based on his or her knowledge "the financial statements, and other financial information included in

[the] report, fairly present¹⁷ in all material respects the financial condition, results of operations and cash flows¹⁸ of the registrant as of, and for, the periods presented in [the] report";

- as to disclosure controls and procedures:

- the CEO and CFO "are responsible for establishing and maintaining disclosure controls and procedures";

- the CEO and CFO have "[d]esigned such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under [their] supervision, to ensure that material information ... is made known to [them] ... particularly during the period in which [the] report is being prepared";

- the CEO and CFO have "[e]valuated the effectiveness of the registrant's disclosure controls and procedures and presented in [the] report [their] conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by [the] report ...";

- as to internal control over financial reporting:

- the CEO and CFO "are responsible for establishing and maintaining ... internal control over financial reporting";

- the CEO and CFO have "[d]esigned such internal control over financial reporting, or caused such internal control over financial reporting to be designed under [their] supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with [GAAP]";¹⁹

- the CEO and CFO have "[d]isclosed in [the] report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting"; and

- the CEO and CFO have "disclosed, based on [their] most recent evaluation of internal control over financial reporting [which must be as of the end of each fiscal year], to the registrant's auditors and the audit committee:

- (a) [a]ll significant deficiencies and material weaknesses²⁰ in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

- (b) [a]ny fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting."

The Section 302 certifications are contained in Item 601(b)(31) of Regulation S-K and must be in the exact form set forth therein. No alteration may be made, "even if the change would appear to be inconsequential in nature."²¹ The certifications must be attached as an exhibit to the reports to which they relate.²² The Section 302 certification may not be signed pursuant to a power of attorney or other form of confirming authority.²³

[b] Penalties

The Section 302 certification adds to the potential liabilities CEOs and CFOs otherwise face as signatories to annual and quarterly reports.ⁿ²⁴ The certification exposes CEOs and CFOs to an increased likelihood of being *personally* targeted as defendants in shareholder suits under Section 10(b) of the 1934 Act, as well as derivative suits if matters turn out to be different than as certified.ⁿ²⁵ Additionally, certifying officers providing false certifications subject themselves and others to potential SEC action and even criminal liability for violating the 1934 Act and the rules thereunder.ⁿ²⁶

[c] Disclosure Controls and Procedures**[i] What Are Disclosure Controls and Procedures?**

The rules adopted pursuant to Section 302 of the Sarbanes-Oxley Act require issuers that file reports under Sections 13(a) or 15(d) of the 1934 Act to establish, maintain and evaluate the effectiveness of an overall system of "disclosure controls and procedures."ⁿ²⁷ Though related, these controls and procedures are different from the "internal control over financial reporting" that relates to an issuer's financial reporting and control of its assets.ⁿ²⁸ Disclosure controls and procedures are: (a) controls and procedures "designed to ensure that information required to be disclosed in [1934 Act reports] is recorded, processed, summarized and reported within the time periods specified in the [SEC's] rules and forms" and include (b) "controls and procedures designed to ensure that information required to be disclosed by an issuer in [its 1934 Act reports] is accumulated and communicated to the issuer's management [(including its CEO and CFO)] ... as appropriate to allow timely decisions regarding required disclosure."ⁿ²⁹

While disclosure controls and procedures overlap with internal control over financial reporting, there are "elements of disclosure controls and procedures that are not subsumed by internal control over financial reporting" and there are "elements of internal control that are not subsumed by the definition of disclosure controls and procedures."ⁿ³⁰ Disclosure controls and procedures should cause timely collection and evaluation of all information (including financial information) potentially subject to disclosure under the requirements of Regulation S-X or Regulation S-K and Forms 20-F and 40-F, as applicable.ⁿ³¹ They should capture information relevant to an assessment of the need to disclose developments and risks that pertain to the issuer's business, and information that must be evaluated in the context of the disclosure requirement of 1934 Act Rule 12b-20.ⁿ³²

[ii] Compliance With the Rules Regarding Disclosure Controls and Procedures

The SEC's rules regarding the establishment, maintenance and evaluation of and disclosure relating to disclosure controls and procedures are found in 1934 Act Rules 13a-15, 15d-15 and Items 307 and 601 of Regulation S-K. Taken as a whole, these rules require the following actions to be taken (in addition to the provision of the certification required under Section 302):

- the issuer must maintain disclosure controls and procedures;ⁿ³³
- the CEO and the CFO must be responsible for establishing and maintaining disclosure controls and procedures;ⁿ³⁴
- the CEO and the CFO must design disclosure controls and procedures (or cause them to be designed under their supervision) to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;ⁿ³⁵
- management must evaluate (with the participation of the CEO and CFO) the effectiveness of the issuer's disclosure controls and procedures as of the end of each fiscal quarter;ⁿ³⁶ and

- the conclusions of the CEO and CFO regarding the effectiveness of the disclosure controls and procedures (based on the evaluation) must be disclosed in each periodic report.ⁿ³⁷

[iii] *Developing Disclosure Controls and Procedures*

As discussed above, an issuer's management (including the CEO and CFO) is required to evaluate the effectiveness of the design and operation of disclosure controls and procedures on a quarterly basis, as of the end of the period covered by the report accompanying the certification required by Section 302 of the Sarbanes-Oxley Act.ⁿ³⁸ The SEC has neither prescribed a specific way in which this evaluation should be undertaken nor discussed whether the scale of the review for annual reports should be different than the scale of the review for quarterly reports. The SEC, however, issued guidance that sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting which would, if the evaluation complied with the guidance, satisfy the evaluation requirements of Exchange Act Rules 13a-15(c) and 15d-15(c).ⁿ³⁹ It is important to note, however, that the guidance is permissive, not mandatory, and that the SEC stressed the importance of management applying a top-down, risk and principle based approach to performing the evaluation over a rote "check-the-box" mechanism. Additionally, although the certification requirements only apply to annual and quarterly reports, a properly designed disclosure controls and procedures system should address all SEC disclosures, including current reports on Form 8-K (which require reporting within four business days of the triggering event), proxy statements and press releases.

While no particular system of disclosure controls and procedures is required by Section 302 or the rules thereunder, the evaluation should at a minimum address the matters specified by the rules.ⁿ⁴⁰ As such, disclosure controls and procedures should allow material information to be presented to the CEO and CFO, particularly during the period in which the periodic report is being prepared. Outside of this, companies should consider developing and maintaining company specific processes that are consistent with their business and internal management and supervisory practices. Companies should consider taking the following steps:

- *Evaluate Current Disclosure Controls and Procedures.* Because the SEC has not mandated the implementation of a particular set of disclosure controls and procedures, CEOs and CFOs may employ those controls and procedures that best suit their company (though CEOs and CFOs should be mindful of the SEC guidance referenced above). The CEO, CFO and other members of senior management must evaluate current disclosure controls and procedures, and in turn, should decide whether those controls and procedures are effective. The circulation, reliability and timeliness of information produced should be considered. The level of involvement of various officers and committees should also be considered, as well as an analysis of the company's current and future business and financial goals.
- *Identify Responsible Parties.* The business units and individuals involved in the disclosure process should be identified and documented. The assessment of responsible parties should be based on a consideration of the organization of a company's business and the applicable disclosure requirements.
- *Establish a Disclosure Committee or Informal Disclosure Group.* The SEC recommends that issuers create committees to consider the materiality of information, determine disclosure obligations on a timely basis and report obligations and information to senior management.ⁿ⁴¹ While the establishment of a disclosure committee is not legally required, many companies have established such committees. Committees can assist companies with focusing, enhancing and monitoring the disclosure process. Though various structures can be effective, companies should consider having the general counsel (or other senior in-house attorneys that deal with disclosure issues), the controller (and assistant controller, as applicable) and others responsible for assembling information to be disclosed in public filings sit on the disclosure committee. It also may be beneficial for other individuals knowledgeable about the corporation's primary business units to serve on the committee.ⁿ⁴² Committees may interface with operating unit heads, as appropriate. Committee members should brief the CEO, the CFO and those other

members of the senior management team "who bear express responsibility for designing, establishing, maintaining, reviewing and evaluating the issuer's disclosure controls and procedures."ⁿ⁴³ In addition to specific disclosure items, disclosure committees can focus on the following issues:

- whether there exist any issues or known risks that may be considered important or material;
- whether anything has occurred during the quarter that causes concern for the head of operating units; and
- whether any accounting issues have been addressed by and discussed with the outside auditors.

Disclosure committees also can establish training programs to help applicable company employees gain an understanding of what types of information may need to be disclosed.ⁿ⁴⁴

■ *Recognize the Need for Real-Time Disclosure.* Public companies are now required to disclose on Form 8-K a variety of developments (some of which previously had been disclosed on Forms 10-Q and 10-K) within four business days of the triggering event. Companies should structure their disclosure controls in light of this four-day reporting requirement, and determine whether a small group or sub-committee should be formed to process information quickly so as to facilitate prompt and timely Form 8-K reporting.

■ *Document Responsibilities.* Establishing a time and responsibility chart for the disclosure process can be useful in developing effective disclosure controls and procedures. The chart should assign principal responsibility for both recording and collecting the information that forms the basis for public disclosures and drafting and circulating the various sections of documents filed with the SEC. The chart should also provide for the evaluation of the effectiveness of disclosure controls and procedures (which must involve supervision and participation by management, including the CEO and CFO) and a review by the CEO and CFO of the periodic reports themselves. Disclosure controls and procedures should also themselves be documented as a formal, documented disclosure procedure is likely to be more efficient than an informal or casual process. Issuers should also consider establishing procedures to collect and retain documentation supporting each of the reports to be certified.

■ *No Selective Disclosure.* Those responsible for disclosure decisions should approve the scope, context and format of disclosure and provide information to the marketplace that is reasonably consistent in tone and presentation (regardless of whether such information is included in SEC filings, press releases or analyst conferences). Inconsistent presentation could result in liability to the company and its officers and directors.ⁿ⁴⁵

■ *Use Backup Certifications.* Many companies have those who oversee operations critical to the company's disclosure procedures deliver signed certifications in support of the CEO's and CFO's mandatory certifications. The backup certifications should be similar in structure to the actual certifications required under the rules, but limited to each individual's area of responsibility. Backup certifications should be drafted carefully, and with an understanding of the responsibilities of their ultimate signatory. Those responsible for divisions or units of the company may not be able to assess accurately overall materiality given their perspective of company affairs.

■ *Design a Scalable System.* In developing disclosure controls and procedures, management should recognize that the procedures employed should be scalable and capable of growing with the company.

■ *Involve the Internal Auditors and Audit Committee.* Internal audit teams (or units performing a similar function) should report information pertaining to disclosure controls and procedures to the CEO and CFO.ⁿ⁴⁶ CEOs and CFOs also generally discuss the company's disclosure controls and procedures with the audit committee (in addition to any discussion with the audit committee regarding internal control over financial reporting).ⁿ⁴⁷

■ *Plan Ahead.* Issuers should consider a "top-down" approach whereby the CEO and CFO assemble those who are involved in the preparation of reports early in the process, especially with the prospect of accelerated reporting deadlines for periodic reports. The CEO and CFO might consider meeting each quarter to discuss what they believe are the important business results, uncertainties and critical accounting issues for that quarter. Employing this type of system can save time and result in improved disclosure.

[d] Internal Control Over Financial Reporting

[i] What Is Internal Control Over Financial Reporting?

The SEC rules adopted pursuant to Sections 302 and 404 of the Sarbanes-Oxley Act require issuers that file reports under Sections 13(a) or 15(d) of the 1934 Act to establish, maintain and evaluate internal control over financial reporting.ⁿ⁴⁸ The certification required by Section 302 enhances the interaction between management (including the certifying officers), the audit committee and outside auditor by requiring the CEO and CFO to disclose to the audit committee (i) all significant deficiencies and material weaknessesⁿ⁴⁹ in the design or operation of internal control over financial reporting and (ii) any fraud involving management or other employees who have a significant role in the company's internal control over financial reporting, and also identify for the outside auditor any material weaknesses in internal control over financial reporting.ⁿ⁵⁰ Insofar as the CEO and CFO are required to discuss and certify as to internal control over financial reporting, they should have a strong grasp of the procedures and information captured within the definition of that term. Together with the other members of senior management, they should gain an understanding of what it means to have effective internal control over financial reporting.

Internal control over financial reporting is defined in 1934 Act Rules 13a-15(f) and 15d-15(f) as:

a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers ... and effected by the issuer's board of directors, management and other personnel, to provide reasonable assuranceⁿ⁵¹ regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with [GAAP] and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [GAAP], and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and the directors of the issuer; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.ⁿ⁵²

The SEC definition of internal control over financial reporting encompasses a subset of the "internal controls" addressed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).ⁿ⁵³

[ii] *Evaluating Internal Control Over Financial Reporting*

Since their adoption, Section 404 of the Sarbanes-Oxley Act and the SEC's related internal control over financial reporting rules have engendered considerable controversy and attention. Public companies have expressed concern over the significant time, costs and resources required to establish, maintain and review a system of internal control over financial reporting.ⁿ⁵⁴ Outside auditors have in no small part contributed to escalating costs as they have been required to expend numerous hours poring through their clients' control systems and documentation--in many cases for the first time. The significance of the undertaking was underscored by the inability of scores of issuers to file their annual reports on Form 10-K with the SEC on a timely basis during the first year of Section 404 compliance.ⁿ⁵⁵ Sensitive to the burden imposed by Section 404 compliance, the SEC has regularly solicited input from the business community on how best to satisfy the Sarbanes-Oxley mandates in an efficient and cost effective manner.ⁿ⁵⁶ The adoption in 2007 of Auditing Standard No. 5 by the PCAOB and the near-simultaneous issuance by the SEC of interpretive guidance designed to assist companies in completing top-down, risk-based evaluations of internal control over financial reporting represent the most recent attempt by the two regulatory to meet that goal, and augmented guidance provided in SEC policy statements in May of 2005.ⁿ⁵⁷

To help address Section 404 compliance issues and to help streamline the internal control evaluation process, in May 2005 the SEC and its Division of Corporation Finance issued policy statements regarding the implementation of internal control reporting requirements.ⁿ⁵⁸ These statements provide that to help increase the efficiency of the Section 404 process, senior management should consider the following concepts in establishing internal control over financial reporting.

- *Employ a "Top-Down", Risk-Based Approach.* The SEC has repeatedly directed management to employ a "top-down", risk-based approach in designing internal control over financial reporting. As such, the creation of internal control over financial reporting should begin with a focus on entity level controls (including the "tone at the top" and company wide programs such as codes of conduct and fraud prevention) and proceed through an analysis of significant processes to individual controls. This type of approach is likely to strengthen controls and communication where necessary, and discourage unnecessary expense with respect to lower risk areas.
- *Customize the Establishment of Controls.* Though there are common controls that must be implemented in all companies, the overall system of internal control over financial reporting, if it is to be effective, cannot amount to a "check the box" approach. In establishing a control environment, the structure and size of the company, the responsible personnel and the nature of the risks the company is exposed to, must all be taken into account.
- *Strengthen Disclosure Controls - Effective Communication is Key.* While internal control over financial reporting and disclosure controls and procedures are not completely subsumed within one another,ⁿ⁵⁹ strengthening disclosure controls and procedures will help disclosable financial information flow through the entity between senior financial officers, the audit committee (and a disclosure committee, if any) the board of directors and the CEO and CFO. An effective system of disclosure controls and procedures is likely to increase the reliability of financial information and help cause such information to be thoroughly and properly evaluated before its ultimate release. The SEC (and the PCAOB) has encouraged management, the audit committee and the outside auditor to communicate openly regarding financial reporting issues.ⁿ⁶⁰ According to the SEC, "[i]nvestors benefit when auditors and management engage in dialogue, including regarding new accounting standards and the appropriate

accounting treatment for complex or unusual transactions."⁶¹ Aside from explicitly required communications, "[b]oth common sense and sound policy dictate that communication must be ongoing and open in order to create the best environment for producing high quality financial reporting and auditing; communications must not be so restricted or formalized that their value is lost."

- *Involve the Audit Committee.* ⁶² The audit committee's participation in establishing and strengthening internal control over financial reporting procedures should include everything from selecting an outside auditor that suits the company, its industry and its control environment to discussing the financial statements and the existence and scope of significant deficiencies and material weaknesses in internal control over financial reporting (including the CEO and CFO). In particular, the SEC "encourage[d] frequent and frank dialogue among management, auditors and audit committees with the goal of improving internal controls and the financial reports upon which investors rely."⁶³

- *Document Controls.* Companies' management, including the CEO and the CFO, should focus their attention on documenting and assessing the effectiveness of their company's internal control structure and procedures for financial reporting. Outside auditors will not be able to gain an understanding of, or assess the effectiveness of and recommend improvements to, their audit clients' system of internal control over financial reporting until controls have adequately been documented by their clients.

In addition to the policy statements described above (regarding management's implementation of internal control over financial reporting), on June 20, 2007 the SEC released interpretive guidance for management to use in conducting its annual evaluation of internal control over financial reporting (required by the rules under Section 404 of the Sarbanes-Oxley Act).⁶⁴ The guidance does not provide a step-by-step roadmap for management to evaluate internal control over financial reporting, nor does it provide a checklist. Rather, the SEC's guidance is principles based and invokes a "top-down", risk-based focus, allowing management to scale its evaluation to fit the facts and circumstances of their companies. The SEC's guidance covers four key areas:

- *Identifying Risks.* The SEC's interpretive management guidance provides that in its evaluation process, management should focus on identifying areas of material risks to financial reporting and controls for addressing these risks. The management guidance urges management to use its judgment in identifying areas where there could be material misstatements and in evaluating related controls to see if the controls address these risks. The management guidance also emphasizes that management does not need to evaluate all controls in a process; rather, management should focus on identifying and evaluating those controls that in its judgment address the risk of material misstatements in financial statements. The SEC also closely aligned its management guidance with the PCAOB's Auditing Standard No. 5 with respect to evaluating whether controls adequately address financial reporting risks, the factors to consider when identifying financial reporting risks and the factors for assessing the risk associated with individual financial reporting elements and controls.

- *Identifying and Evaluating Operation of Controls.* The management guidance provides that once the relevant controls are identified, management should align its evaluation methods so that they are focused on analyzing those areas that present the highest risk to reliable financial reporting. The management guidance includes examples of ways that management can substantiate its evaluation; this aspect of the guidance is designed in part to limit the amount of testing that management is required to undertake. The guidance also includes an expanded discussion of entity-level controls and how these controls should be designed and evaluated.

- *Reporting the Results of Management's Evaluation.* The SEC's management guidance includes examples of what are strong indicators of a material weakness. These indicators have been aligned with those found in the PCAOB's Auditing Standard No. 5.

- *Documentation.* The SEC's management guidance indicates that management should take steps to evaluate whether reasonable documentation is maintained with respect to those controls that form the basis for management's evaluation. The guidance expresses that there is no prescribed form of documentation and that management should use its judgment as to the form and extent of documentation maintained.n65

Though the SEC has indicated that there are various different ways for management to conduct its evaluation, following the SEC's management guidance will provide companies with a "safe harbor" under the 1934 Act.n66

[iii] Compliance With the Rules Regarding Internal Control Over Financial Reporting

The SEC's rules regarding the establishment, maintenance, evaluation of and disclosure relating to internal control over financial reporting adopted pursuant to Sections 302 and 404 of the Sarbanes-Oxley Act are found in 1934 Act Rules 13a-15, 15d-15 and Items 308 and 601(b)(31) of Regulation S-K, and the PCAOB's rules relating to internal control over financial reporting are found in Auditing Standard No. 5.n67 Taken together, these rules require the following actions to be taken (in addition to the provision of the certification required by Section 302):

- the issuer must establish and maintain internal control over financial reporting;n68
- the CEO and the CFO must be responsible for establishing and maintaining internal control over financial reporting and design internal control over financial reporting (or cause it to be designed under their supervision) to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP;n69
- the CEO and the CFO must disclose, based on their most recent quarterly evaluation of internal control over financial reporting, to the company's auditors and audit committee:
 - all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting;n70
- management must evaluate (with the participation of the CEO and CFO) any change in the issuer's internal control over financial reporting that occurred during each of the issuer's fiscal quarters and materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting and any such changes must be disclosed in Forms 10-Q and 10-K;n71
- management must evaluate (with the participation of the CEO and CFO) the effectiveness of the issuer's internal control over financial reporting as of the end of each fiscal year and include a report on internal control over financial reporting in each annual report;n72 and
- the outside auditor's report on internal control over financial reporting must be included in each annual report.n73

[iv] Management's Report on Internal Control Over Financial Reporting

As mentioned above, in addition to the establishment and evaluation of internal control over financial reporting,

pursuant to the rules of the SEC adopted under Sections 302 and 404 of the Sarbanes-Oxley Act, an issuer must include in each Form 10-K filed with the SEC a report of management on internal control over financial reporting.ⁿ⁷⁴ Each such report must include the following:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- a statement identifying the framework used by management to conduct its assessment of the effectiveness of the registrant's internal control over financial reporting;ⁿ⁷⁵
- an assessment of the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year, including an explicit statement as to whether internal control over financial reporting is effective;ⁿ⁷⁶ and
- a statement that the registered public accounting firm that audited the financial statements included in the annual report issued an attestation report on the registrant's internal control over financial reporting."ⁿ⁷⁷

Issuers must also include the auditor's opinion as to the effectiveness of internal control over financial reporting.ⁿ⁷⁸ The outside auditors' opinions relating to internal control over financial reporting is discussed in §14.08[5] below.ⁿ⁷⁹

[e] Disclosure Required by Items 307 and 308 of Regulation S-K

The rules under Sections 302 and 404 of the Sarbanes-Oxley Act and the certification requirement under Section 302 of the Sarbanes-Oxley Act place general requirements on companies to establish, maintain and evaluate disclosure controls and procedures and internal control over financial reporting.ⁿ⁸⁰ Items 307 and 308 of Regulation S-K complement these rules and the related certification requirements by requiring companies to disclose management's evaluation of these governance items and the outside auditor's report on internal control over financial reporting.ⁿ⁸¹ Item 307 of Regulation S-K requires disclosure of the conclusions reached by the CEO and CFO in evaluating the effectiveness of the registrant's disclosure controls and procedures (based on their required evaluation).ⁿ⁸² Item 308 of Regulation S-K requires disclosure of management's annual report on internal control over financial reporting, a related report of the company's outside auditor and a statement as to whether any changes in internal control over financial reporting have occurred.ⁿ⁸³ Because these disclosure requirements obligate companies to present evaluations of controls and procedures to their investors, companies should be even more cognizant of the effectiveness and efficiency of such controls and procedures.ⁿ⁸⁴

[3] The Section 906 Certification

Section 1350 of Chapter 63, Title 18 of the United States Code (as amended by Section 906 of the Sarbanes-Oxley Act) requires any periodic report containing financial statements and filed with the SEC pursuant to Section 13(a) or 15(d) of the 1934 Act to be accompaniedⁿ⁸⁵ by a certification by the CEO and CFO. This Section 906 certification must state that:

- the periodic report containing the financial statements fully complies with the requirements of Section 13(a) or 15(d) of the 1934 Act; and
- the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.ⁿ⁸⁶

In order to avoid falsely certifying as to the information contained in a periodic report, CEOs and CFOs should be

vigilant in confirming that effective systems of disclosure controls and procedures and internal control over financial reporting are in place.

Because Section 1350 is a criminal provision, criminal penalties can be imposed on CEOs and CFOs who provide false certifications. If the CEO or CFO provides a certification "knowing" the report it accompanies does not comport with the requirements of Section 1350, he or she may be fined up to one million dollars, imprisoned for up to ten years, or both.ⁿ⁸⁷ If the CEO or CFO provides a certification "willfully knowing" that the periodic report does not comport with Section 1350, the maximum fine is increased to five million dollars, and the maximum prison term to twenty years.ⁿ⁸⁸ Although the penalties for a false certification require a "knowing" or "willful" failure to comport with the requirements of Section 1350, the express language of the certification does not refer to the knowledge of the CEO or CFO (unlike the language of the Section 302 certification). The Department of Justice has confirmed that the certifying officer may qualify the certification to his or her knowledge, as knowledge is a necessary element of a criminal act of miscertification. Several companies have added knowledge or best knowledge qualifiers to Section 906 certifications.ⁿ⁸⁹

[4] Self-Regulatory Organization Certifications

On November 4, 2003, the SEC approved the NYSE's final proposed amendments to its Listed Company Manual. Included in the rules, as they have been subsequently amended, is Section 303A.12(a), a requirement that the CEO of any NYSE listed company certify to the NYSE that, as of the date of the certification, he or she is not aware of any violation by the company of any of the NYSE corporate governance listing standards. The rules require the certification to be disclosed in the company's annual report to shareholders, or if the company does not prepare an annual report to shareholders, in its annual report on Form 10-K.ⁿ⁹⁰ Complementing the certification requirement is Section 303A.12(b) which requires listed company CEOs to notify the NYSE promptly when an executive officer of the company becomes aware of any material non-compliance with a NYSE corporate governance listing standard. In 2005, the NYSE proposed additional changes to its corporate governance listing standards. Among the proposed changes were: (1) a proposal to eliminate the requirement that listed companies disclose in their annual reports that they have filed the NYSE corporate governance certification and the SEC certifications; and (2) a proposal to have CEOs notify the NYSE in writing promptly after any executive officer of the listed company becomes aware of *any* non-compliance (as opposed to requiring notification only in the event of a *material* non-compliance). The proposed rule changes do not become effective until they are approved by the SEC.

Companies with their securities listed on the Nasdaq Stock Market are required to have a duly authorized officer certify that the company is in compliance with Nasdaq's audit committee composition, audit committee charter, nominating committee charter, executive session and code of conduct requirements. Listed companies were required to submit this certification by the earlier of (i) the company's first annual stockholder meeting after January 15, 2004 and (ii) October 31, 2004. Foreign private issuers and small business issuers were permitted to submit the certification by July 31, 2005.ⁿ⁹¹ After the initial certification, an updated form need only be provided to the Nasdaq Stock Market if a change in the company's status has occurred causing the prior form to no longer be accurate.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. *See* Sarbanes-Oxley Act §§ 302 and 906, 15 U.S.C. § 7241 and 18 U.S.C. § 1350 (2007). Section 302(a) of the Sarbanes-Oxley Act directed the SEC to adopt rules requiring certification. Prior to adopting formally the certification requirements which are set forth in the 1934 Act Rules and Regulation S-K, on June 27, 2002, the SEC issued a one time order requiring CEOs and CFOs of public companies with revenues over \$1.2 billion to file certifications individually with the SEC on August 14, 2002. The SEC's Rules pursuant to the Sarbanes-Oxley Act were then initially adopted by the SEC in SEC Release No. 33-8124 (Aug. 29, 2002). These rules were subsequently amended concurrently with the SEC's adoption of rules relating to Section 404 of the Sarbanes-Oxley Act in SEC Release No. 33-8238 (June 5, 2003). Section 906 of Sarbanes-Oxley is itself an amendment to the United States Criminal Code. The certification requirements were a response to events such as the Congressional testimony of former Enron CEO Jeffrey Skilling who claimed to be ignorant of Enron's accounting details. Sarbanes-Oxley Act §§ 302, 404 and 906, and related implementing rules, are reproduced in Appendix E to this treatise. The certification requirements apply equally to issuers *required* to make filings under the 1934 Act and to issuers voluntarily filing reports, pursuant to an indenture covenant or otherwise.

(n2)Footnote 2. The meaning of "disclosure controls and procedures" and "internal control over financial reporting" are discussed in § 14.02[2] *below*.

(n3)Footnote 3. The specific requirements of the Section 302 certification are discussed in § 14.02[2][a] *below*.

(n4)Footnote 4. *See* Sarbanes-Oxley Act § 906, 18 U.S.C. § 1350.

(n5)Footnote 5. 1934 Act Rules 13a-15 and 15d-15, 17 CFR §§ 240.13a-15, 240.15d-15 (2009). 1934 Act Rules 13a-15 and 15d-15 are reproduced in Appendix E to this treatise.

(n6)Footnote 6. 1934 Act Rules 13a-15 and 15d-15, 17 CFR §§ 240.13a-15, 240.15d-15 (2009).

(n7)Footnote 7. 1934 Act Rules 13a-15 and 15d-15, 17 CFR §§ 240.13a-15, 240.15d-15 (2009).

(n8)Footnote 8. 1934 Act Rules 13a-15 and 15d-15, 17 CFR §§ 240.13a-15, 240.15d-15 (2009).

(n9)Footnote 9. The rules requiring this disclosure were adopted in connection with the SEC's rule releases relating to Section 302 of the Sarbanes-Oxley Act, but the structure and mechanics of such rules were subsequently revised in connection with the SEC's rule release implementing Section 404 of the Sarbanes-Oxley Act. *See* SEC Release No. 33-8238 (June 5, 2003).

(n10)Footnote 10. *See* Regulation S-K Item 307, 17 CFR § 229.307 (2009). Regulation S-K Items 307 and 308 are reproduced in Appendix E to this treatise. The SEC has also adopted interpretive guidance to management on how to conduct its evaluation of internal control over financial reporting. This guidance is discussed in greater detail in § 14.02[2][d] *below*. Additionally, the Public Company Accounting Board's Auditing Standard No. 5, which became effective on July 27, 2007, provides standards and guidelines for independent auditors to attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting. *See* PCAOB Auditing Standard No. 5 (July 27, 2007).

(n11)Footnote 11. *See* Regulation S-K Item 308(c), 17 CFR § 229.308(c) (2009).

(n12)Footnote 12. *See* Regulation S-K Item § 229.308, 17 CFR § 308 (2009) and PCAOB Auditing Standard No. 5 (July 27, 2007). Management's and the outside auditor's report on internal control over financial reporting are discussed further in § 14.02[2][d] and § 14.08[5] *below*, respectively.

(n13)Footnote 13. Backup certifications are discussed in § 14.02[2][c] *below*.

(n14)Footnote 14. Companies should also consider reviewing director and officer liability insurance coverage as

well as their charter and bylaws in order to enhance protections where possible. Indemnification of directors and officers is discussed further in Chapter 5 *above*.

(n15)Footnote 15. Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31) (2009)*. Item 601(b)(31) of Regulation S-K is reproduced in Appendix E to this treatise.

(n16)Footnote 16. This portion of the certification reflects the anti-fraud disclosure standard of 1934 Act Rule 12b-20. Note that this prong of the Section 302 certification expressly includes a materiality standard. The Section 906 certification, on the other hand, does not contain any materiality or knowledge qualifiers. *See § 14.02[3] below* for further discussion of the use of a knowledge qualification in the Section 906 certification.

(n17)Footnote 17. The term "fairly present" was intended by the SEC to be broader than mere conformity with GAAP. Rather, the certification must provide assurance of overall material accuracy and completeness including an assessment of whether the accounting principles selected are appropriate under the circumstances, whether the disclosure is informative and reasonably reflects the underlying transactions and events and whether any additional disclosure is necessary to provide investors with a materially accurate and complete picture of the company's fiscal condition, results of operations and cash flows. Note that the certification covers not only financial statements, but all financial information, including footnotes, selected financial data and management's discussion and analysis and parts of the certification cover the entire report. *See SEC Release No. 33-8124 (Aug. 29, 2002)*.

(n18)Footnote 18. The SEC deviated from the actual text of Section 302 by adding the term "cash flows" to the certification. The SEC explained that "it is consistent with Congressional intent to include both income or loss and cash flows within the concept of 'fair presentation' of an issuer's results of operations." *SEC Release No. 33-8124 (Aug. 29, 2002)*.

(n19)Footnote 19. In its adopting release to the rules under Section 404 of the Sarbanes-Oxley Act and subsequent releases extending the Section 404 compliance dates, the SEC stated that the portion of the certification relating to the design of internal control over financial reporting need not be included until management is required to provide its internal control report. *See § 14.02[2][d][ii]*.

(n20)Footnote 20. "Significant deficiency" and "material weaknesses" are defined terms under the rules and standards adopted by the SEC and PCAOB for implementation of Section 404 of the Sarbanes-Oxley Act. *See § 14.02[2][d][i]* for a discussion of these terms.

(n21)Footnote 21. *SEC Release No. 33-8124 (Aug. 29, 2002)*. Notwithstanding this requirement, certain changes to the certification have been permitted. For example, before the SEC's rules under Section 404 of the Sarbanes-Oxley Act become effective with respect to a company, that company's certifications do not have to include certain provisions that relate to internal control over financial reporting. *See § 14.02[2][d][iv] below*. Additionally, the text of the certification may change depending upon the type of report in which the certification is included and whether the CEO and CFO are different individuals.

(n22)Footnote 22. Note that although the Section 302 and Section 906 certifications must both be attached as exhibits to SEC filings, the Section 302 certification is "filed", but the Section 906 certification is "furnished" (and thus not subject to liability under Section 18 under the 1934 Act and not incorporated in registration statements under the 1933 Act unless the company specifically takes steps to include or incorporate the certificate in such registration statements). The basis for permitting the Section 906 certification to be deemed "furnished" rather than filed is the language in Section 906 of the Sarbanes-Oxley Act requiring each periodic report to "be accompanied by" the Section 906 certification. Section 302, on the other hand, requires the certifications to be included "in" the periodic report. The SEC adopted the rules requiring companies to "furnish" the Section 906 certification as an exhibit and to "file" the 302 certification as an exhibit in June 2003. *See SEC Release No. 33-8238 (June 5, 2003)*. Both certification requirements apply equally to issuers *required* to make filings under the 1934 Act and to issuers *voluntarily* filing reports, pursuant to

an indenture covenant or otherwise.

(n23)Footnote 23. Pursuant to Rule 302(b) of Regulation S-T, each signatory to an electronic filing must manually sign a signature page authenticating the signature that appears in the electronic filing at or before the time of filing. This manual signature must be retained by the issuer for a period of five years. *See* Regulation S-T Rule 302(b), *17 CFR* § 232.302(b) (2009). Rule 302(b) applies to both the Section 302 and the Section 906 certifications.

(n24)Footnote 24. CEOs and CFOs already face liability pursuant to Sections 13(a) and 18 of the 1934 Act.

(n25)Footnote 25. *See* HuberJack S. Levin, Laurence A. Urgenson *How CEOs, CFOs Can Avoid Criminal Exposure Under Sarbanes-Oxley Certification Process* (Oct. 2002) at <http://www.kirkland.com/sitecontent.cfm?contentID=223&itemId=2510>. Charles M. Nathan, *The Sarbanes-Oxley Act: A Spotlight On Individual Officers, Directors and Legal Counsel*, NCMA GLASS-CLE 319 (Aug. 2002).

(n26)Footnote 26. On March 19, 2003, the SEC filed accounting fraud charges in federal district court in the Northern District of Alabama against HealthSouth Corporation and its CEO and chairman, Richard M. Scrushy. In the first prosecution under the Sarbanes-Oxley Act, the SEC's complaint alleged (i) since 1999, at Scrushy's insistence, HealthSouth systematically overstated its earnings and (ii) when Scrushy certified the accuracy and completeness of HealthSouth's financial statements, he knew or was reckless in not knowing they were materially false and misleading, and in November 2003, Scrushy was indicted on charges of securities fraud and other violations. *See* SEC Lit. Release No. 18044 (Mar. 20, 2003). Though Scrushy ultimately was acquitted of all charges in his criminal case on June 28, 2005, the case highlighted the Department of Justice's ability and willingness to bring a criminal action based on the certification requirements of the Sarbanes-Oxley Act. The SEC moved forward in its civil case despite Scrushy's acquittal. *See* Commission's Response to Order to Show Cause, filed on July 7, 2005 in N.D. Ala. Civil Action No. CV-03-J-0615-S entitled SEC v. HealthSouth Corporation and Richard M. Scrushy. Scrushy ultimately settled the civil case with the SEC for \$81 million. *See* SEC Lit. Release No. 20084 (Apr. 23, 2007).

(n27)Footnote 27. *See* 1934 Act Rules 13a-15 and 15d-15, *17 CFR* §§ 240.13a-15, 240.15d-15 (2009). These rules are reproduced in Appendix E to this treatise.

(n28)Footnote 28. *See* 1934 Act Rules 13a-15(f) and 15d-15(f), *17 CFR* §§ 240.13a-15(f), 240.15d-15(f) (2009).

(n29)Footnote 29. *See* 1934 Act Rules 13a-15(e) and 15d-15(e), *17 CFR* §§ 240.13a-15(e), 240.15d-15(e) (2009).

(n30)Footnote 30. SEC Release No. 33-8238 (June 5, 2003). *See generally* SEC Release No. 33-8138 (Oct. 22, 2002). For example, disclosure controls and procedures do include the components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP. According to Alan Beller, who was Director of the SEC's Division of Corporation Finance at the time these rules were adopted, because the two sets of controls are not subsumed within one another, it is theoretically possible that an issuer can conclude that its disclosure controls and procedures are effective even though it has identified a material weakness in internal control over financial reporting. Mr. Beller noted, however, that the threshold for reaching that conclusion is a high one. *See* SEC "Hot Topics" Teleconference, SEC, PCAOB Internal Controls Over Financial Reporting: New Regulations, July 20, 2004. Internal control over financial reporting is described in more detail in § 14.04[2][d] below. The SEC also stated that portions of the broad COSO description of internal controls (such as the efficiency and effectiveness of a company's operations and the company's compliance with laws and regulations, generally) do not fall within the definition of internal control over financial reporting or disclosure controls and procedures. The overlap between the COSO definition of internal controls and the term internal control over financial reporting is described in more detail in § 14.02[2][d][i] below.

(n31)Footnote 31. *See* SEC Release No. 33-8124 (Aug. 29, 2002).

(n32)Footnote 32. *See* SEC Release No. 33-8124 (Aug. 29, 2002).

(n33)Footnote 33. *See* 1934 Act Rules 13a-15(a) and 15d-15(a), *17 CFR §§ 240.13a-15(a), 240.15d-15(a)* (2009).

(n34)Footnote 34. *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n35)Footnote 35. *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n36)Footnote 36. *See* 1934 Act Rules 13a-15(b) and 15d-15(b), *17 CFR §§ 240.13a-15(b), 240.15d-15(b)* (2009). The CEO and CFO are also required to certify as to this fact. *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n37)Footnote 37. *See* Regulation S-K Items 307 and 601(b)(31), *17 CFR §§ 229.307, 601(b)(31)* (2005). *See* Rules 13a-15(d) and 15d-15(d), *17 CFR §§ 240.13a-15(d), 240.15d-15(d)* (2005).

(n38)Footnote 38. *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n39)Footnote 39. *See* SEC Release No. 33-8810 (June 27, 2007).

(n40)Footnote 40. *See* SEC Release No. 33-8124 (Aug. 29, 2002).

(n41)Footnote 41. *See* SEC Release No. 33-8124 (Aug. 29, 2002).

(n42)Footnote 42. "Disclosure Committee Best Practices," Foley & Lardner, LLP (March 2007), *available at* http://www.foley.com/files/tbl_s31Publications/FileUpload137/4083/DisclosureCommitteeBestPractices.pdf.

(n43)Footnote 43. SEC Release No. 33-8124 (Aug. 29, 2002).

(n44)Footnote 44. "Disclosure Committee Best Practices," Foley & Lardner, LLP (March 2007), *available at* http://www.foley.com/files/tbl_s31Publications/FileUpload137/4083/DisclosureCommitteeBestPractices.pdf.

(n45)Footnote 45. In *SEC v. Siebel Systems, Inc., Kenneth A. Goldman and Mark D. Hanson*, the first SEC enforcement action charging a violation of 1934 Act Rule 13a-15 (requiring issuers to maintain effective disclosure controls and procedures), Siebel's CEO and former investor relations director provided disclosure to certain investors and industry professionals in a private meeting that the SEC contended was materially different from earlier public disclosures made by the company. The SEC asserted that the selective disclosure amounted to a Regulation FD violation and that the company should have promptly filed a Form 8-K disclosing any material non-public information revealed in the private meeting. The court ultimately dismissed both the Rule 13a-15 claim (on the basis that the SEC has not provided particular factual allegations to establish that material non-public information was disclosed selectively) and the Regulation FD claim. *See SEC v. Siebel Systems, Inc., Kenneth A. Goldman and Mark D. Hanson*, (S.D.N.Y. Aug. 31, 2007).

(n46)Footnote 46. Note that all companies with securities listed on the NYSE are required to maintain an internal audit function. *See* NYSE Listed Company Manual § 303A.07(d). *See § 14.03 below* for a discussion of the internal audit team and the internal audit function.

(n47)Footnote 47. The role of the audit committee is discussed in Chapter 9 *above*.

(n48)Footnote 48. In addition, since 1977, Section 13(b)(2)(B) of the 1934 Act, adopted as part of the Foreign Corrupt Practices Act of 1977, has required public companies to maintain a system of "internal accounting controls". *See 15 USCS § 78m*.

(n49)Footnote 49. The Sarbanes-Oxley Act did not define the terms "significant deficiency" or "material weakness" but these terms were defined by the Public Company Accounting Oversight Board in 2004 and revised by the PCAOB and by the SEC in rules adopted in June 2007 and August 2007, respectively. *See* SEC Release No.

33-8809 (June 20, 2007) and SEC Release No. 33-8829 (Aug. 3, 2007). The definitions of both terms are now contained in Rule 12b-2 under the 1934 Act. Rule 12b-2 under the 1934 Act defines a "material weakness" as a "deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis" and defines a "significant deficiency" as a "deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." *See 17 CFR § 240.12b-2 (2009)*. The Public Company Accounting Oversight Board, in its Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements", uses the same definitions for these terms. *See PCAOB Auditing Standard No. 5 PP A7 and A11 (July 27, 2007)*. The term "deficiency" is not defined in the SEC's rules, but is defined in Auditing Standard No. 5 to exist "when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis." *See PCAOB Auditing Standard No. 5 P A3 (July 27, 2007)*.

(n50)Footnote 50. *See Regulation S-K Item 601(b)(31), 17 CFR § 229.601(b)(31) (2009)*.

(n51)Footnote 51. The term "reasonable assurance" refers to the concept that "absolute assurance" is not attainable because of the nature of audit evidence and the characteristics of fraud. *See PCAOB Auditing Standard No. 5, P Introduction 3 (July 27, 2007)*. *See also SAS No. 1, "Due Professional Care in the Performance of Work," AU § 230*.

(n52)Footnote 52. 1934 Act Rules 13a-15(f) and 15d-15(f), *17 CFR §§ 240.13a-15(f), 240.15d-15(f) (2009)*. *See PCAOB Auditing Standard No. 5 P A5 (July 27, 2007)*.

(n53)Footnote 53. *See Committee of Sponsoring Organizations of the Treadway Commission, Internal Control--Integrated Framework 3-9 (1992)*. In 1992 COSO produced a report entitled "Internal Control--Integrated Framework". According to the COSO framework, internal controls relate to an issuer's financial reporting and control of assets. Specifically, "internal controls" refer to a process, effected by the company's management (including the CEO and CFO), board of directors and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in three categories: (1) effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with applicable laws and regulations. Internal control over each of these objectives consists of the following five interrelated components: (1) the control environment; (2) risk assessment; (3) control activities; (4) information and communication; and (5) monitoring. The three objectives represent what the company wishes to achieve, while the five components represent the methodology required to achieve those goals. *See Committee of Sponsoring Organizations of the Treadway Commission, Internal Control--Integrated Framework 4 (1992)*. In 1995, the AICPA's Auditing Standards Board codified this definition of internal controls in Statement on Auditing Standards No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55" (1995). The Auditing Standards Board confirmed this definition in Statement on Auditing Standards No. 109, "Understanding the Entity and its Environment and Assessing the Risks of Material Mismanagement" (2006).

On June 5, 2003, the SEC adopted final rules defining and employing the term "internal control over financial reporting". This term is used in the SEC's rules and certification requirements under Sections 302 and 404 of the Sarbanes-Oxley Act. The SEC's term, "internal control over financial reporting" encompasses that portion of the "internal controls" addressed in the COSO framework that pertains to financial reporting objectives, but does not encompass that portion of "internal controls" that relates to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations (with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as SEC financial reporting obligations). *See SEC Release No. 33-8238 (June 5, 2003)*. However, both the SEC's internal control over financial reporting rules, as well as the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 5 (discussed in § 14.08[5] below) state that the framework used to evaluate internal control over financial reporting must be based on "suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." *See 1934 Act Rules 13a-15(c) and*

15d-15(c), and PCAOB Auditing Standard No. 5, P Introduction 5 (July 27, 2007). The PCAOB references the COSO framework as such a standard, and bases the performance and reporting directions in Auditing Standard No. 5 on the COSO framework. In the release adopting these rules, the SEC explained that while the COSO framework satisfies these criteria, the rules do not mandate the use of a particular framework, such as that set forth in the COSO framework. *See* SEC Release No. 33-8238 (June 5, 2003). Given the criteria set forth by the SEC and the PCAOB, domestic companies may find the COSO framework to be the only viable option that satisfies the requirements of the rules. On July 11, 2006, COSO also published guidance on the use of the COSO framework to address the needs of smaller business in fulfilling the requirements of Section 404. *See* Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control over Financial Reporting - Guidance for Small Public Companies* (2006). On February 4, 2009, COSO published additional guidance intended to clarify the monitoring component of internal control, suggesting ways in which organizations can effectively focus their efforts to evaluate monitoring and ensure proper follow-up of any identified deficiencies. *See* Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control over Financial Reporting - Guidance on Monitoring Internal Control Systems* (2009).

(n54)Footnote 54. CFOs in particular have spent a much larger portion of their days focussing on compliance, especially relating to Section 404. An April 2005 study indicated that senior financial executives (CFOs and controllers) expected to spend as much as a quarter of their time on compliance with internal control rules in 2005 and a fifth of their time on it in 2006. *See Sarbanes-Oxley: What Happened, What's Next and How to Protect Your Company From the Biggest Emerging Risks*, CFO Executive Board, April 7, 2005, at 4. An April 2006 study by CRA International Inc. (which was commissioned by Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP), however, revealed that total Section 404 compliance costs for companies with market capitalization over \$700 million averaged approximately \$8.5 million in 2004 and \$4.8 million in 2005. For smaller companies, those with market capitalization between \$75 million and \$700 million, average Section 404 costs were \$1.24 million in 2004 and \$860,000 in 2005. CRA INT'L, *SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES: SPRING 2006 SURVEY UPDATE* (Apr. 17, 2006), *available at* http://www.s-oxinternalcontrolinfo.com/pdfs/CRA_III.pdf. A similar study produced by Financial Executives International, an advocacy group for financial executives, indicated that on average, companies paid approximately \$3.8 million each in 2005 in Section 404 compliance costs, down 16% from 2004. *See* Financial Executives International, *FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping; Average Compliance Costs are \$3.8 Million, Down 16% from Prior Year; Reductions About Half of What Were Anticipated* (April 6, 2006), *available at* fei.mediaroom.com/index.php?s=press_release&item=74. A 2004 case study showed that the internal hours spent on assessment were 12 times higher than the SEC's initial 2002 estimate and attestation fees (audit fees) increased by 50% in the first year of Section 404 compliance. *See* Lineke Sneller and Henk Langendijk, "Sarbanes Oxley Section 404 Costs of Compliance: A Case Study," 15 *Corp. Gov.: An Int'l Rev.* 101, 109 (March 2007).

Note, however, that research firms such as Glass Lewis & Co. point out that material weaknesses continue to abound. Glass Lewis & Co.'s research shows that while 10.0% of U.S. public companies disclosed material weaknesses in 2005, 8.8% of U.S. public companies also disclosed material weaknesses in 2006. *See* Grothe, Mark et. al., *The Materially Weak*, Glass Lewis & Co. 1 (Feb. 27, 2007). The SEC continues to monitor the costs of compliance. The Office of Economic Analysis led a study through the second half of 2008, open to all companies with experience complying with 404 rules, as part of an effort to improve "the efficiency and cost-effectiveness of the implementation of Section 404's requirements, particularly for smaller companies." SEC Press Release 2008-116 (June 20, 2008) *available at* <http://www.sec.gov/news/press/2008/2008-116.htm>. The survey is at <http://404survey.sec.gov>, and general information about the survey is at <http://www.sec.gov/spotlight/404survey.htm>.

(n55)Footnote 55. To address this issue, the SEC extended its Section 404 compliance date several times.

Most of the extensions have expired, except for the Section 404(b) compliance deadline for all non-accelerated filers, who are not be required to comply with Section 404(b) until the filer's annual report for the first fiscal year ending on or after December 15, 2009. *See* SEC Release No. 33-8934 (June 26, 2008). During the first year of compliance, filers that

include an annual report with management's assessment on internal control over financial reporting, but not the outside auditor's report, can "furnish" rather than "file" management's report. The SEC has indicated that newly public companies would not have to comply with the internal control related requirements under Section 404 until they file their second annual report as a public company. *See* SEC Release No. 33-8760. The SEC has suggested that there will be no further extensions of this deadline. *See As 404(b) Nears, Small Filers Hear Advice*, Compliance Week (Apr. 21, 2009).

(n56)Footnote 56. A recent example is the web-based study of the costs and benefits of Section 404 of the Sarbanes-Oxley Act publicized on the SEC web site through late 2008 and early 2009, which generated responses from more than 2,000 businesses.. Information on the study *available at* <http://www.sec.gov/spotlight/404survey.htm>.

(n57)Footnote 57. *See* SEC Release No. 33-8809 (June. 20, 2007). Accounting Standard No. 5 is discussed in § 14.08[5] below.

(n58)Footnote 58. *See* SEC Division of Corporation Finance, Office of the Chief Accountant, *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (May 16, 2005); SEC, *Commission Statement on Implementation of Internal Control Reporting Requirements* (May 16, 2005).

(n59)Footnote 59. The interrelation between the two terms is discussed in *Section 14.02[2][c][i]*.

(n60)Footnote 60. According to the SEC and the PCAOB, management may ask the outside auditor accounting, auditing and financial reporting questions and provide the outside auditor with early drafts of the financial statements without impairing independence or triggering a control deficiency (as long as management makes the final determination regarding the accounting to be used and does not rely on the outside auditor to design or implement the controls). Further, in evaluating internal control over financial reporting, the PCAOB's Auditing Standard No. 5 encourages the outside auditor to use the work of other individuals.

(n61)Footnote 61. SEC Division of Corporation Finance, Office of the Chief Accountant, *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (May 16, 2005).

(n62)Footnote 62. The audit committee is discussed in Chapter 9 above.

(n63)Footnote 63. SEC, *Commission Statement on Implementation of Internal Control Reporting Requirements* (May 16, 2005).

(n64)Footnote 64. *See* SEC Release No. 33-8810 (June 27, 2007).

(n65)Footnote 65. *See* SEC Release No. 33-8810 (June 27, 2007).

(n66)Footnote 66. *See* SEC Release No. 33-8809 (June 20, 2007).

(n67)Footnote 67. After the PCAOB voted to adopt Auditing Standard No. 5, it became effective when it was approved by the SEC pursuant to SEC Release No. 34-56152 on July 27, 2007. The PCAOB is discussed in § 08[4] below.

(n68)Footnote 68. *See* 1934 Act Rules 13a-15(a) and 15d-15(a), *17 CFR §§ 240.13a-15(a), 240.15d-15(a)* (2009). *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n69)Footnote 69. *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n70)Footnote 70. *See* Regulation S-K Item 601(b)(31), *17 CFR § 229.601(b)(31)* (2009).

(n71)Footnote 71. *See* 1934 Act Rules 13a-15(d) and 15d-15(d), *17 CFR §§ 240.13a-15(d), 240.15d-15(d)* (2005).

See Regulation S-K Items 308(c) and 601(b)(31), 17 CFR §§ 229.308(c), 229.601(b)(31) (2009).

(n72)Footnote 72. Note that the internal control report must be provided by "management" as opposed to just the issuer's chief executive officer and chief financial officer. The contents of management's report on internal control over financial reporting is discussed in § 14.02[2][d][iv] below. See Regulation S-K Item 308(a), 17 CFR § 229.308(a) (2009), 1934 Act Rules 13a-15(c) and 15d-15(c), 17 CFR §§ 240.13a-15(c), 240.15d-15(c) (2009). The SEC Staff noted that management's report included in the Form 10-K should be located in close proximity to the corresponding report of the outside auditor on internal control over financial reporting, and that both reports should be placed together near management's discussion and analysis or immediately preceding the financial statements. See SEC, Division of Corporation Finance, Staff Alert-Annual Report Reminders (Mar. 4, 2005).

(n73)Footnote 73. See Regulation S-K Item 308(b), 17 CFR § 229.308(b) (2009). The outside auditor's report on internal control over financial reporting is discussed in § 14.08[5] below.

(n74)Footnote 74. See Regulation S-K Item 308(a), 17 CFR § 229.308(a) (2009). See 1934 Act Rules 13a-15(c) and 15d-15(c), 17 CFR §§ 240.13a-15(c) and 240.15d-15(c) (2009).

(n75)Footnote 75. Appropriate frameworks for conducting the required evaluation are discussed in § 14.02[2][d][i] above.

(n76)Footnote 76. Management may not conclude that internal control over financial reporting is effective if a material weakness is identified. The meaning of material weakness is discussed in § 14.02[2][d][i]14.02[2][d][i] above.

(n77)Footnote 77. Regulation S-K Item 308(a)(4), 17 CFR § 229.308(a)(4) (2009). This attestation must be made in accordance with the PCAOB's Auditing Standard No. 5 discussed in § 14.08[5] below.

(n78)Footnote 78. See Regulation S-K Item 308(b), 17 CFR § 229.308(b) (2009). See PCAOB Auditing Standard No. 5 P71-74 (July 27, 2007).

(n79)Footnote 79. The SEC's rules requiring the inclusion of management's internal control report and the auditor's related opinions are described in footnote 51. Upon effectiveness of the internal control report rules with respect to an issuer, each of the following requirements become effective: (a) Items 308(a) and 308(b) of Regulation S-K (the internal control report and auditor's opinions); (b) 1934 Act Rules 13a-15(a) and 15d-15(a) (requiring issuers to maintain internal control over financial reporting); and (c) the requirements of 13a-15(c) and 15d-15(c) (requiring issuers' management to evaluate the effectiveness of internal control over financial reporting). See SEC Release No. 33-8238 (June 5, 2003) and SEC Release No. 33-8392 (Feb. 24, 2004). An issuer can omit certain portions of the Section 302 certification until it files its first Form 10-K containing an internal control report.

(n80)Footnote 80. 1934 Act Rules 13a-15 and 15d-15 call for the maintenance and evaluation of disclosure controls and procedures and internal control over financial reporting, and Item 601(b)(31) of Regulation S-K requires the CEO and CFO to certify as to the establishment, maintenance, design and evaluation of disclosure controls and procedures and internal control over financial reporting. These requirements are described in greater detail above.

(n81)Footnote 81. The Item 307 and 308 disclosure is required under Item 4 of Part I of Form 10-Q and Item 9A of Part II of Form 10-K. Note the Section 302 certification set forth in Item 601(b)(31) of Regulation S-K requires the certifying officer to state that he or she has "[d]esigned such disclosure controls and procedures ... to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to them by others within those entities" It is unclear exactly what language should be used in the Item 307 disclosure as the Section 302 certification itself contains a materiality qualification, whereas Rules 13a-15(a) and 15d-15(a) under the 1934 Act require issuers to maintain disclosure controls and procedures without regard to the materiality of the information disclosed. It seems a materiality qualification may be permissible in the Item 307 disclosure in order to conform the

disclosure to the language contained in the CEO's and CFO's certification, but the SEC has not clarified this point. The placement of the reports on internal control over financial reporting are described in greater detail in § 14.02[2][d][iv] above .

(n82)Footnote 82. Because disclosure controls and procedures are defined as a process designed to "ensure" that information required to be disclosed is processed, summarized and reported in a timely manner, some companies have indicated in their Item 307 disclosure that disclosure controls and procedures are designed only to provide "reasonable assurance" that the controls and procedures will meet their objectives. The SEC has stated it generally will not object to this type of disclosure so long as it is accompanied by the CEO's and CFO's conclusions that the disclosure controls and procedures are actually effective at the "reasonable assurance" level. *See* SEC Release No. 33-8238 (June 5, 2003). On the other hand, the concept of reasonable assurances is specifically built into the definition of "internal control over financial reporting".

(n83)Footnote 83. Management's reporting on internal control over financial report is discussed in § 14.02[d][iv] above and the outside auditor's related report is disclosed in § 14.08[5] below .

(n84)Footnote 84. Note that as the SEC has not provided any insight into the breadth of the required Item 307 disclosure, a variety of practices have developed. Some issuers have provided boilerplate type responses to Item 307. Other companies have provided detailed disclosure regarding the types of control mechanisms employed, the effectiveness and deficiencies of those controls and the scope of the control evaluation.

(n85)Footnote 85. Although Section 1350 only states that the report must be "accompanied" by the certification, Item 601(b)(32) of Regulation S-K provides that the Section 906 certification must be filed as an exhibit to periodic reports. The SEC has stated that this exhibit will be deemed "furnished" rather than "filed," thereby not subjecting the issuer to liability under Section 18 of the 1933 Act and causing the certification to not be incorporated in registration statements under the 1933 Act unless the company specifically takes steps to include or incorporate the certificate in such registration statements.

(n86)Footnote 86. *See* Sarbanes-Oxley Act § 906, 18 U.S.C. § 1350(b).

(n87)Footnote 87. *See* Sarbanes-Oxley Act § 906, 18 U.S.C. § 1350(c)(1).

(n88)Footnote 88. *See* Sarbanes-Oxley Act § 906, 18 U.S.C. § 1350(c)(2).

(n89)Footnote 89. In extremely rare occasions, certain other changes to the certification may be appropriate. For example, Alan Beller, former director of the Division of Corporation Finance informally noted that where an issuer filed its Form 10-K in a timely manner but could not complete its Section 404 evaluation on time (and thus the Form 10-K did not include management's assessment and the auditor's opinions on internal control over financial reporting), although the wording of the certification could not be changed, the SEC would not object to an additional statement noting that the Form 10-K is being filed without the assessment and auditor's report because the assessment could not be completed.

(n90)Footnote 90. *See* NYSE Listed Company Manual § 303A.12. The NYSE also requires listed companies to specify and disclose any qualification to the certification be specified and disclosed, to the extent necessary, submit an executed Written Affirmation annually relating to compliance with the corporate governance rules, and submit an Interim Written Affirmation any time there is any change to the board or the audit, compensation or nominating committee.

(n91)Footnote 91. *See* Nasdaq Stock Market Corporate Governance Certification Form at www.nasdaq.com/about/CG_Certification_Form.pdf. Companies are not required to provide the certification annually, but must update their certification if it becomes inaccurate. *See* Nasdaq Frequently Asked Questions at www.nasdaq.com/about/FAQsCorpGov.stm.



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Corporate Governance: Law and Practice

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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.03

AUTHOR: John F. Olson Ari B. Lanin

§ 14.03 The Internal Audit Function and Head of the Internal Audit

[1] Internal Auditors and the Internal Audit Function

[a] Overview and Responsibilities

The Institute of Internal Auditors defines the internal audit function as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."¹ This function has grown to become an integral component of a system of sound corporate governance.

While the Sarbanes-Oxley Act does not itself require companies to maintain an internal audit function, it does require companies to maintain and evaluate a system of internal control over financial reporting.² The NYSE, however, has adopted a rule *requiring* each listed company to maintain an internal audit function so as to provide management and the audit committee with ongoing assessments of the company's risk management process and system of internal control.³ The NYSE rule does not require listed companies to dedicate a full time internal audit staff or create a separate internal audit department. Rather, listed companies may satisfy the requirement either by using in-house positions or by outsourcing the job to an accounting firm other than the company's outside auditor.⁴

The internal auditors oversee the company's internal audit function. Their primary role is to evaluate objectively and report on the effectiveness of the company's risk management, control and governance processes.⁵ In carrying out this role, the internal auditors often take on the following responsibilities:

- assisting the audit committee and management team in the development of a comprehensive approach to the implementation, management, and evaluation of internal controls and educating management as to its internal control responsibilities;⁶
- assisting the audit committee and management team with the evaluation of internal controls and providing the audit committee and management team with vital information about the weaknesses in

internal controls;ⁿ⁷

- assisting the CEO and CFO with the certifications required under Section 302 of the Sarbanes-Oxley Act;
- helping to ensure that information presented to the board of directors and the audit committee is factual and relevant;
- monitoring and reporting on the processes employed to ensure that significant risk exposures are understood and managed appropriately and assisting management with the development of an annual risk assessment;
- reviewing the financial statements for errors, misstatements and potential fraud;
- providing feedback to senior management and the board of directors regarding the effectiveness of the internal audit program;ⁿ⁸
- assisting management with its preparation of management's internal control report;ⁿ⁹ and
- monitoring the ethical climate and providing assurance that good governance principles are practiced.

However, in light of the emergence of numerous unanticipated risks exposed by the rapid economic downturn of 2008 and 2009, it has been suggested that a reexamination of the function of internal auditors may be in order. Since 2003, a significant portion of internal auditor responsibilities have been focused on financial reporting controls in response to Sarbanes-Oxley. While such heavy emphasis may have been appropriate in the immediate aftermath of its adoption, the dramatic declines in share value accompanying the economic downturn have revealed that rigorous compliance and monitoring in accordance with Sarbanes-Oxley may provide insufficient protection to shareholders. Sarbanes-Oxley risks are now thought to be generally well controlled, and thus a partial realignment of responsibilities is due. As a result, there has been movement away from the familiar activities of monitoring and compliance - increasing amounts of which can be handled by automated data-mining operations - toward forward-looking risk management activities that pose the greatest long-term risks to companies.ⁿ¹⁰

In shaping the internal audit function and choosing the appropriate internal auditors, companies should consider the following:

- *In-House Personnel May be Used.* Even though an in-house internal audit function is not required by the NYSE Listed Company Manual rules or the Sarbanes-Oxley Act or the rules adopted thereunder, many companies have a staff of in-house internal auditors, as in-house internal auditors may be more likely to have in-depth, sophisticated and current knowledge of the company's business and affairs. Other companies, particularly smaller enterprises, have outsourced the entire internal audit function.ⁿ¹¹ Although companies should maintain employees familiar with the execution of the internal audit function, no one structure is appropriate for all companies.

- *Meet With the Audit Committee and Management.* The head of internal audit should attend all regularly scheduled audit committee meetings and maintain a direct and ongoing line of communication with the audit committee and management. Meetings should take place both within and outside the presence of management. The audit committee should be responsible for the oversight of the internal audit function, and should exercise due care and see that the internal audit team is performing effectively, and is sufficiently staffed and adequately trained.ⁿ¹²

- *Use Management's Internal Control Over Financial Reporting Assessment.* Working closely with management in its self-assessment of internal control over financial reporting (required by Section 404 of the Sarbanes-Oxley Act and the rules thereunder) can help the internal auditors more efficiently implement and identify weaknesses in internal control over financial reporting.ⁿ¹³

- *Establish a Direct Line of Communication Between the Internal and Outside Auditors.* Establishing a direct line of communication between the internal and outside auditors can increase the efficiency of the audit performed by the outside auditor and help the outside auditor gather information with respect to its internal control report (required by Section 404 of the Sarbanes-Oxley Act and the rules thereunder as well as the PCAOB's Auditing Standard No. 2).

[b] The Internal Audit Team

Because the internal audit function requires a broad range of tasks and responsibilities, the internal audit team should consist of individuals who possess a broad range of skills, knowledge and disciplines. The internal audit team, as a whole, should have the following abilities and attributes:

- proficiency in applying accounting and internal auditing standards, procedures and techniques;
- knowledge of fundamental accounting, economics, commercial law, taxation, finance, quantitative methods, and information technology concepts;
- an understanding of management principles that allow for the evaluation of the materiality and significance of deviations from good business practice;
- knowledge of the company's industry and business practices;
- sufficient communication skills to clearly and effectively report on engagement objectives, evaluations, conclusions and recommendations; and
- integrity, professionalism and objectivism.ⁿ¹⁴

[2] Head of Internal Audit

The head of internal audit, or chief internal auditor, directs the company's internal audit function and coordinates the internal audit team. In addition to assisting and managing the internal audit services discussed in § 14.03[1] above, the head of internal audit's responsibilities may include:

- staffing the in-house internal audit team, if any;
- establishing policies and procedures for the internal audit team and assisting in the determination of the company's long-term audit plan;
- reviewing the company's business practices and procedures;
- auditing compliance with corporate policies, procedures and regulations;
- investigating allegations of code of conduct and ethics violations;

- assisting management and the audit committee with respect to compliance with the Sarbanes-Oxley Act and other applicable rules and regulations;
- evaluating the company's governance processes;
- testing for whether the company is working toward its strategic long term goals;
- advising and counseling the company on its efficiency and effectiveness in risk management;
- evaluating the company's internal controls and determining whether the company's documented internal control structure is, in practice, being followed; and
- assisting in the determination of whether the company's internal controls are adequate.¹⁵

In order to fulfill his or her duties and responsibilities effectively, the head of internal audit should, at a minimum, have a strong background in accounting, internal auditing standards and general auditing methodologies and practices. He or she should be capable of auditing financial, operational and information technology functions and should have a thorough understanding of internal controls.¹⁶ The head of internal audit should also be more than an accountant, but rather an executive who is capable of understanding the company's long term strategy and addressing internal and external organizational trends. Because the head of internal audit regularly interacts with the audit committee, outside auditor and management, he or she should also be an effective communicator with strong character and should have the ability to earn the respect of the audit committee and senior management. Effective communication with management can provide a forum for criticism and evaluation of internal control over financial reporting, accounting strategies and corporate strategies ultimately employed by senior management. And of course, the head of internal audit should have a reputation for integrity and a strong understanding of the company's business.

The audit committee should either appoint the head of internal audit or be heavily involved in and ratify his or her appointment. The audit committee should also play an important role with respect to the head of internal audit's compensation and scope of responsibilities and make the post an opportunity for advancement, rather than a dead-end position. Once appointed, the head of internal audit should report directly to the audit committee and the CEO or CFO and should have ongoing access to and dialogue with the audit committee.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview Securities Law Additional Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act Securities Law Self-Regulating Entities National Securities Exchanges New York Stock Exchange

FOOTNOTES:

(n1)Footnote 1. *See* The Institute of Internal Auditors - Definition of Internal Auditing, *at* <http://www.theiia.org/guidance/standards-and-guidance/ippf/definition-of-internal-auditing>.

(n2)Footnote 2. An internal audit function has been suggested by the Conference Board's Blue Ribbon Commission on Public Trust and Private Enterprise. The Treadway Commission also suggested that the SEC require public companies maintain an internal audit function. *See* Committee of Sponsoring Organizations of the Treadway Commission, Internal Control--Integrated Framework 88-89 (1992).

(n3)Footnote 3. *See* NYSE Listed Company Manual § 303A.07(d) Commentary.

(n4)Footnote 4. An accounting firm providing the internal audit function could not be the company's outside auditor as Section 201 of the Sarbanes-Oxley Act and Rule 2-01 of Regulation S-X prohibit the outside auditor from performing certain non-audit services, including internal audit services. Prohibited non-audit services are discussed in *Section 14.08[2] below*.

(n5)Footnote 5. *See* Board of Governors of the Federal Reserve System, Interagency Policy on the Internal Audit Function and its Outsourcing 5 (Mar. 17, 2003). The Interagency Policy was issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision and reflects these agencies' guidance on the independence of accountants who provide auditing services in light of the Sarbanes-Oxley Act.

(n6)Footnote 6. As one commentator has noted, "with its knowledge, skills and experience - there's typically no better group than internal audit to comprehend, document, and test the enterprise's internal control over financial reporting, or to monitor remediation efforts." Richard M. Steinberg, *For Chief Audit Executives: Getting Back to Your Day Job*, Compliance Week, July 19, 2005.

(n7)Footnote 7. *See* Board of Governors of the Federal Reserve System, Interagency Policy on the Internal Audit Function and its Outsourcing 1 (Mar. 17, 2003).

(n8)Footnote 8. A lack of adequate feedback to the board and senior management has been cited as a common organizational flaw in the run up to the 2008 financial crisis. *See* Norman Marks, *A New OECD Report Points the Way: The Opportunity, If Not the Obligation, for Internal Auditors* (March 5, 2009), at <http://www.theiia.org/blogs/marks/index.cfm/post/A%20New%20OECD%20Report%20Points%20the%20Way:%20The%20Opportunity,%20If%20Not%20the%20Obligation,%20for%20Internal%20Auditors>.

(n9)Footnote 9. Management's internal control report is discussed in *Section 14.02[2][d][iv] above*. The internal auditors can assist management by instructing them as to their responsibilities relating to internal control over financial reporting and helping to evaluate the implementation, management and monitoring of internal control activities. Recently, internal audit departments have found themselves devoting increased time to preparing the internal reports required by Sarbanes-Oxley. *See* Cynthia Harrington, *Internal Audit's New Role*, Journal of Accountancy, Sept. 2004, at <http://www.journalofaccountancy.com/Issues/2004/Sep/InternalAuditSNewRole.htm>.

(n10)Footnote 10. *See* PriceWaterhouseCoopers, *Business Upheaval: Internal Audit Weighs its Role Amid the Recession and Evolving Enterprise Risks* (March 2009), at http://www.thecorporatecounsel.net/AccountingDisclosure/member/FAQ/InternalAuditors/03_09_Pwc.pdf.

(n11)Footnote 11. *See* KPMG, *The Case for Sourcing Internal Audit* (June 2008), at http://www.thecorporatecounsel.net/AccountingDisclosure/member/FAQ/InternalAuditors/06_08_internal.pdf.

(n12)Footnote 12. *See* John F. Olson, *How to Really Make Audit Committees More Effective*, 54 *Bus. Law.* 1097, 1109 (1999). The audit committee is discussed in further detail in Chapter 9 above.

(n13)Footnote 13. Management's evaluation of internal control over financial reporting is described in § 14.02[2][d][ii].

(n14)Footnote 14. *See* Richard Tan, *Built to Last*, Institute of Internal Auditors, Inc., Dec. 1, 2002, at 4.

(n15)Footnote 15. *See* Richard Tan, *Built to Last*, Institute of Internal Auditors, Inc., Dec. 1, 2002, at 2.

(n16)Footnote 16. *See* Richard Tan, *Built to Last*, Institute of Internal Auditors, Inc., Dec. 1, 2002, at 2.



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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.04

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§ 14.04 The Corporate Secretary

[1] Role, Responsibilities and Characteristics

In many companies a key coordinator of corporate governance functions is the corporate secretary. While in the past the position had been regarded as a "combination of scrivener and custodian,"ⁿ¹ the corporate secretary's role and responsibilities have evolved to include: (1) drafting and maintaining corporate records; (2) assuring a smooth information flow between management, the board of directors, the shareholders and regulatory agencies; and (3) monitoring the corporate governance process and assisting in the implementation of effective corporate governance, generally.ⁿ² Often assisted by an assistant corporate secretary and others, including the legal department, corporate secretaries provide the following functions, among others:ⁿ³

- *Assistance with Board and Committee Meetings.* The corporate secretary can play a considerable role in structuring the agenda for board meetings, alerting the CEO and/or chairman of the board as to topics that should be considered at meetings and drafting and distributing board minutes.ⁿ⁴ To this end, the corporate secretary should also prepare board books containing information, issues and documents to be discussed at board meetings. The corporate secretary can also help new directors become familiar with the company by offering informational orientation programs.ⁿ⁵

- *Assistance with Shareholder Meetings.* The corporate secretary is generally responsible for overseeing the preparation of the proxy statement and notice of meeting, which may involve coordinating the input of attorneys, personnel, financial groups, directors and senior management members. This task may also involve negotiations with shareholder groups over shareholder proposals and related discussions with the board of directors, management and the SEC. The corporate secretary should work closely with senior management in preparing the script and agenda for the annual meeting and should assist in ensuring an impartial tabulation of the shareholder vote.

- *Maintenance of Corporate Records.* Corporate secretaries are generally responsible for the maintenance of corporate records and assist with the filing, protection, indexing and updating of such

records.n6

- *Interaction with Exchanges.* The corporate secretary can act as the corporate liaison with the exchanges on which his or her company's shares are listed. In this respect, he or she is in a unique position to determine and improve compliance with listing requirements, including corporate governance listing standards.

- *Acting as Liaison Between Corporate Participants.* The corporate secretary often handles shareholder relations matters and acts as the liaison between management and the directors.

- *Assistance with Compliance Matters.* Depending on his or her background, the corporate secretary can also play a role in the drafting of disclosure documents, including current, quarterly and annual reports, registration statements, and insider trading reports. In many cases the corporate secretary acts as the monitor of the company's pre-clearance policy, putting him or her in a unique position to monitor compliance with SEC insider trading rules and company pre-clearance procedures.

Given the significance of the corporate secretary's role, choosing an effective corporate secretary is an important part of maintaining a sound system of corporate governance. The Society of Corporate Secretaries & Governance Professionals suggested that a successful corporate secretary have the following personal and professional attributes:

- a thorough understanding of the company's business;
- a basic knowledge of corporate and securities law;
- knowledge of the rules of the stock exchange on which the company's securities are listed;
- solid communication skills;
- sensitivity to the thoughts and sentiments of the CEO and board of directors;
- ability to read signals on the horizon and provide early warnings to management;
- ability to mediate and achieve consensus;
- knowledge of how to overcome bureaucratic thinking in the company;
- detail-oriented perspective;
- flexibility and creativity; and
- the ability to maintain a sense of humor and balance, regardless of the situation.n7

[2] Board Information

[a] Board Orientation Programs

In order to be effective, directors must understand their company, its business and the industry as a whole. The corporate secretary can increase director awareness, the company's level of compliance and help to make governance efforts more successful by providing new directors with orientation programs upon their election. Such orientation programs should involve both the provision of information and discussions with various company personnel. The

information provided should describe the requirements of the position, discuss pertinent company policies (including corporate governance policies) and legal requirements and explain applicable securities laws and regulations.ⁿ⁸ Copies of the company's recent SEC filings can also be included to give new board members a better understanding of the company's business and disclosure techniques. Biographies of the other board members can be distributed as well. The corporate secretary should also arrange for other orientation activities, as appropriate, including: (1) on-site visits with members of management and tours of company facilities; (2) discussions with management relating to company structure and goals; (3) question and answer sessions relating to structure, culture and dynamics of the industry in which the company operates; and (4) presentations on disclosure controls, procedures and responsibilities, internal controls and applicable accounting rules.ⁿ⁹ While all orientation programs should give new directors the opportunity to gain a practical understanding of how the company operates, they should not be conducted with a "one size fits all" mentality. Programs should be tailored to the company's business and industry and to each individual director's experience and needs.

[b] Director Education

Corporate secretaries play a critical role in assisting in the education of the directors on an ongoing basis.ⁿ¹⁰ In addition to initial orientation programs, opportunities should be offered for directors to refresh and update their skill set and knowledge base.ⁿ¹¹ Corporate secretaries can offer directors the opportunity to attend various programs relating to industry issues, accounting developments and the evolution of corporate governance best practices (such as issues relating to independence, the effectiveness and composition of committees, compliance and ethics programs, etc.). Director education programs relating to corporate governance are offered by myriad organizations, including proxy voting services and corporate governance ratings agencies.

[c] Information to the Board

As explained by the Conference Board in its Corporate Governance Best Practices report, "[t]he effectiveness of the board ultimately depends on the quality and timeliness of information disposal each director receives."ⁿ¹² As such, the corporate secretary can help to enhance the effectiveness of the directors by overseeing the preparation of the board book for each meeting of the board. These packages should contain all the materials directors need to review in preparing for a meeting, including the board's proposed agenda drafted by the chair, issues for discussion, proposed resolutions requiring board action and any documents (and ancillary materials) that directors should review during board meetings. Because directors should be given ample time to review and absorb relevant information, board books should be distributed several days before the date of the meeting. Only in those situations where materials are either unavailable or extremely confidential should directors be presented with information at the start of the meeting.ⁿ¹³

Additionally, board members can be updated between meetings with packages containing management information, analyst reports, articles and news clippings that discuss the company, relevant issues or industry news.ⁿ¹⁴ Boards can also be provided with industry information, including updates on competitors.

In assembling board information, corporate secretaries should be mindful of the volume of information provided to directors. While providing too little information can be dangerous, providing too much material can obscure the most relevant information.ⁿ¹⁵ To help directors avoid unintentionally overlooking important information provided in board packages, corporate secretaries may choose to classify documents into various categories that promote efficient processing.ⁿ¹⁶ Significant time and cost savings can result from the corporate secretary using email and fax to disseminate information and from using email alerts to advise directors of meeting agendas, reports and other materials.ⁿ¹⁷ Additionally, directors should be given the opportunity to meet with division managers and members of senior management on an ongoing basis so as to keep apprised of current issues faced by the company and the industry as a whole.

[3] Minutes

[a] Purpose of Minutes

Corporate minutes serve as a record of the discussions and deliberations of the board of directors and its committees.ⁿ¹⁸ Properly drafted, maintained and organized minutes can be an excellent source of board considerations and historical information as well as a company's first and best line of defense against litigation. The availability of the business judgment rule, for example, could hinge on the process observed by the directors as described in the structure and wording of the minutes.ⁿ¹⁹ Further, as the discovery process in a lawsuit may not begin until well after the precipitating event (and sometimes not until years after the beginning of litigation), corporate minutes can become the best source of available evidence in a lawsuit.ⁿ²⁰

The corporate secretary should consider the following principles when drafting corporate minutes: (1) minutes should be drafted with a focus on process so as to communicate the board's commitment to due care, loyalty, knowledge and thorough review; (2) minutes should not be used to express views or opinions; (3) writing style should be neutral; (4) word choice and consistent word use is critical;ⁿ²¹ and (5) minutes should be prepared soon after the applicable board or committee meeting. No one style is appropriate for every company. Further, because of their potential importance to the company's welfare, minutes should always be reviewed by the directors (or committee members, as applicable) as soon as possible after a meeting.ⁿ²²

[b] Style and Length of Minutes

There is little legal guidance as to what type of information corporations should include in minutes or what form they should take. Abbreviated style, or short form minutes, are concise and unambiguous, but may not present a completely clear picture of what occurred at a particular meeting. In many circumstances, the corporate secretary may find it desirable to detail the board's diligence in dealing with a particular issue. Long form minutes, while they provide evidence of the board's evaluation and a clearer picture of the total deliberation process, are more likely to provide an increased opportunity for misinterpretation.ⁿ²³

The corporate secretary needs to choose the appropriate drafting style based upon the subject matter being dealt with at a particular meeting. For example, deliberations relating to material acquisitions may require the provision of additional information while ordinary course meetings may be better suited to a more summary style.ⁿ²⁴ The corporate secretary should also be careful to indicate the length and breadth of discussion spent by the board on certain issues. Minutes should generally give more attention to those areas explored by the board in greater detail, and less attention to less material items. This may give the reader a better sense of time and process. Regardless of the detail presented, minutes are generally best drafted articulating the overall discussion, rather than the comments of individuals. It is important that minutes indicate not only subjects discussed, but key issues and questions raised and the degree of active director participation. For executive sessions, the presiding director should give the corporate secretary a short statement of the matters discussed and of any decisions made. After they are drafted, minutes should be circulated to all directors (or committee members, as applicable) for review and comment. Comments (but not necessarily approval) should be requested from directors within a week or two of the meeting, so directors can more easily confirm the accuracy of the description of discussions and the inclusion of all substantive matters.

When determining the detail and length of board minutes, boards of directors and their general counsel and corporate secretary should also consider whether and to what extent directors should take notes during meetings. Because notes taken by directors may be discoverable, directors often agree that corporate minutes, rather than personal notes, should act as the sole record of board and committee meetings.ⁿ²⁵

After minutes are approved, the corporate secretary should evaluate the most appropriate method in which they should be stored.ⁿ²⁶ While minutes have traditionally been kept in paper form and stored in binders, developments in technology have allowed many companies to save minutes and other corporate records electronically on hard drives using databases, document management systems, internet web portals and in many cases, even inexpensive off the shelf

word processing software. n27 Saving minutes electronically can provide many advantages, among them: (1) the ability to search for and retrieve information contained within corporate records; (2) a reduced need for physical storage space; (3) cost savings relating to reduced legal fees (in situations where minutes are stored by a company's law firm); and (4) the ability to duplicate or transmit entire sets of minutes quickly and inexpensively and, when necessary cut and paste from or redact out various types of information.n28

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityMeetingsProceduresBusiness & Corporate LawCorporationsGoverning Documents & ProceduresRecords & Inspection RightsRecordkeepingBusiness & Corporate LawCorporationsShareholdersMeetings & VotingGeneral Overview

FOOTNOTES:

(n1)Footnote 1. *See* Society of Corporate Secretaries & Governance Professionals *The Corporate Secretary--Duties and Responsibilities*, at

http://www.governanceprofessionals.org/society/The_Corporate_Secretary_-_Duties_and_Responsibilit.asp?SnID=1031255750. The Society of Corporate Secretaries & Governance Professionals, Inc. ("Society") was founded in 1946 and has over 3,800 members representing approximately 2,600 companies. The Society deals with matters affecting corporate governance, including the structure and meetings of the board of directors and its committees, investor relations and shareholder meetings. *See* Society of Corporate Secretaries & Governance Professionals website, at <http://www.governance.professionals.org>.

(n2)Footnote 2. *See* Society of Corporate Secretaries & Governance Professionals, *The Corporate Secretary--Duties and Responsibilities*, at

http://www.governanceprofessionals.org/society/The_Corporate_Secretary_-_Duties_and_Responsibilit.asp?SnID=1031255750; David W. Smith, *The Emergence of the Corporate Secretary*, 6 *Insights*, June 1992, at 2.

(n3)Footnote 3. *See* David W. Smith, *The Emergence of the Corporate Secretary*, 6 *Insights*, June 1992, at 2.

(n4)Footnote 4. The importance of appropriately drafted corporate minutes is discussed in § 14.04[3] below.

(n5)Footnote 5. Such orientation programs are discussed in *Section 14.04[2][a]* below.

(n6)Footnote 6. *See generally* Yin Wilczek, *SEC Enforcement: SEC Official Reminds Companies to Heed Books, Records, Internal Control Issues*, Corporate Accountability Report, Apr. 24, 2009.

(n7)Footnote 7. *See* Society of Corporate Secretaries & Governance Professionals, *The Corporate Secretary--Duties and Responsibilities*, at <http://www.governanceprofessionals.org/duties/index.shtml>.

http://www.governanceprofessionals.org/society/The_Corporate_Secretary_-_Duties_and_Responsibilit.asp?SnID=1031255750. For further discussion, including perspectives on whether the corporate secretary and general counsel roles should be combined, see also *Are You Cut Out to Be a Corporate Secretary?*, ACC Docket, September 2008; *The Role of the Corporate Secretary in the New Post-Sarbanes/Oxley Arena*, The Metropolitan Corporate Counsel, April 2008; *The Society of Corporate Secretaries & Governance Professionals: Building on Achievements of the Past, Helping Its Members Discharge Their Role as the Conscience of the Corporation, and Drawing on the Expertise of Its Members to Provide Input to Key Regulatory and Policy Making Bodies*, The Metropolitan Corporate Counsel, April 2008; *Enlightened Corporate Governance: At the Center of the Discussion of the Corporate Secretary's Role*, The Metropolitan Corporate Counsel, April 2007; and *The Society of Corporate Secretaries & Governance Professionals: Charting a New Course*, The Metropolitan Corporate Counsel, April 2005.

(n8)Footnote 8. Such descriptions can include the mechanics of Rule 144, Form 144 and Forms 3, 4 and 5, required to be filed under Section 16(a) of the 1934 Act. A description of the company's insider trading policy and legally or company imposed trading restrictions should be included as well.

(n9)Footnote 9. *See generally* Deborah S. Rade, *Director Orientation and Continuing Education*, Practising Law Institute: Corporate Law and Practice Course Handbook Series, PLI Order No. 18176, March-June 2009; Dorothy K. Light and Richard W. Leblanc, *Integrating the New and Educating the Current Director*, 1 (July 1993).

(n10)Footnote 10. *See* Deborah S. Rade, *Director Orientation and Continuing Education*, Practising Law Institute: Corporate Law and Practice Course Handbook Series, PLI Order No. 18176, March-June 2009; *Corporate Secretary Perspective; American Society of Corporate Secretaries: Cutting Edge Resources for Corporate Governance in Today's Complex Business Environment*, The Metropolitan Corporate Counsel, April 2003.

(n11)Footnote 11. Various shareholder activist groups have criticized public companies for not disclosing whether their directors are offered the opportunity to participate in continuing education programs.

(n12)Footnote 12. *See* The Conference Board, *Corporate Governance Handbook* 18 (2005).

(n13)Footnote 13. *See generally* Broc Romanek (editor of GreatGovernance.com), *Board Materials*, at <http://www.thecorporatecounsel.net/GreatGovernance/member/FAQ/BoardMaterials.htm>.

(n14)Footnote 14. *See Corporate Secretary Perspective; A New Era in Corporate Governance: How Corporate Secretaries Are Coping with the Challenges*, The Metropolitan Corporate Counsel, April 2003. According to Stephen J. Paul, Assistant Corporate Secretary and Senior Counsel of Shell Oil Company, "assistance from the directors is needed to support and encourage management in making investments in technology which, properly employed, can make all aspects of the corporate secretary function, particularly interaction with the directors, more effective and efficient."

(n15)Footnote 15. *See generally* Marc Morgenstern, *Sarbanes-Oxley's Subtle Disclosure Costs*, Insights, January 2007 (explaining that when "[p]repared with foresight and care, the board package can minimize liability; inadequately prepared it can create liability" (*emphasis original*)).

(n16)Footnote 16. Romanek, suggests classifying information into types such as "regular", "exception" "lag" and "lead". "Regular" refers to information that is shared on a predetermined schedule. "Exception" refers to information reported only when it deviates from the normal. "Lag" refers to information about the company's performance. "Lead" refers to information about where the company or its industry may be heading. *See* Broc Romanek, *Board Materials* at www.thecorporatecounsel.net/GreatGovernance/member/FAQ/BoardMaterials.htm; *see also* Marc Morgenstern, *Sarbanes-Oxley's Subtle Disclosure Costs*, Insights, January 2007 (recommending, for example, including clear distinctions in board packages between forecasts (what management believes will occur) and hypothetical calculations (what may occur)).

(n17)Footnote 17. *See Corporate Secretaries and Corporate Governance Professionals: Helping Corporate Secretaries Ensure Top-Flight Operations*, The Metropolitan Corporate Counsel, April 2005. Additionally, other electronic tools such as virtual boardrooms, compliance calendars, and records centers can greatly enhance a corporate secretary's efficiency and accuracy. *See New Compliance Tools for the Corporate Secretary*, The Metropolitan Corporate Counsel (April 2007). With the advent of the internet, corporate secretaries have been able to provide their directors with board information in easy to access electronic forms. In addition to e-mail, various companies offer products that manage documents and communications relating to board meetings so that board members are automatically notified of meetings set by the corporate secretary and can access a secure site from anywhere to view the documents pertinent to the meeting. *See New Compliance Tools for the Corporate Secretary*, The Metropolitan Corporate Counsel (April 2007).

(n18)Footnote 18. The Delaware General Corporation Law provides that "[o]ne of the officers of [the corporation]

shall have the duty to record the proceedings of the meetings of the stockholders and directors in a book to be kept for that purpose." *Del. Code Ann. tit. 8, § 142(a)* (2007). The Model Business Corporation Act provides that "[a] corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors ... [and a] corporation shall maintain its records in written form or in another form capable of conversion into written form within a reasonable time." Model Bus. Corp. Act § 16.01 (2009).

(n19)Footnote 19. The "business judgment rule" provides that decisions of directors if challenged in court, will be upheld if they are rationally related to a legitimate business purpose.

(n20)Footnote 20. Connie R. Gale, *When Minutes Count: What A Corporate Secretary Should Keep In Mind*, Bus. Law Today, Jan./Feb. 1997, at 36.

(n21)Footnote 21. Connie R. Gale, *When Minutes Count: What A Corporate Secretary Should Keep In Mind*, Bus. Law Today, Jan./Feb. 1997, at 36. For example, use of the word "discussion" may be more appropriate than use of the word "argue." Further, as words can often take on unintended meanings, varying word choices throughout minutes should be avoided. Minutes should be drafted in as consistent a manner as possible.

(n22)Footnote 22. *In re Netsmart Techs. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007), where the court granted shareholders' motion for a preliminary injunction against the consummation of a merger pending further disclosure, demonstrates the significance of this point. In that case, a special committee approved minutes of ten previous meetings dating back several months at one time (and only after litigation for this case commenced). Vice Chancellor Strine noted "[t]hat tardy, omnibus consideration of meeting minutes is, to state the obvious, not confidence-inspiring" *Id.* at 191. This analysis prompted a renewed surge of advisories on the importance of timely review. See, e.g., Cullen M. Godfrey, *In re the Walt Disney Company Derivative Litigation: A New Standard for Corporate Minutes*, 17-Aug Bus. L. Today 47, 49-50 (July/Aug. 2008).

(n23)Footnote 23. Society of Corporate Secretaries and Governance Professionals, *Corporate Minutes: A Monograph for the Corporate Secretary* 12 (2006). At a minimum, corporate minutes should include: (1) the meeting date and time and list of attendees; (2) the topics discussed; (3) the matters voted on and outcome of such vote; (4) whether anyone abstained from voting or certain discussions; (5) the material terms and rationale of any decision; (6) the individual who prepared the minutes; and (7) the time of adjournment. See American Bar Association Committee on Corporate Laws, *Corporate Director's Guidebook* 5th Ed. 45 (2008).

(n24)Footnote 24. The Delaware Chancery Court decision, *In re The Walt Disney Company Derivative Litig.*, handed down in May 2003, suggests that increased attention should be invested in the drafting of corporate minutes. See *In re The Walt Disney Company Derivative Litig.*, 825 A.2d 275 (2003). There, the company's board of directors approved the hiring of Disney's new president (a close personal friend of the CEO) after practically no review of the terms of his employment or the employment agreement itself. In concluding that plaintiffs' complaint sufficiently alleged a breach of the directors' obligation "to act honestly and in good faith in the corporation's best interests ... [such that the] directors' conduct fell outside the protection of the business judgment rule," the court noted that "[l]ess than one and one-half pages of the fifteen pages of ... minutes were devoted to discussions of [the] hiring[,] ... [n]o presentations were made to the [board] regarding the terms of the draft agreement[,] ... [n]o questions were raised, at least so far as the minutes reflect [and] ... no expert consultant was present to advise the compensation committee or the [board]." *Disney*, 825 A.2d at 287.

While the Delaware Supreme Court ultimately found that the board's actions were protected under the business judgment rule, the Chancery Court decision nonetheless evidences the willingness of courts to review corporate minutes closely in reviewing a board's deliberative process. *In re The Walt Disney Company Derivative Litig.*, 906 A.2d 27 (Del. Jun. 8, 2006).

(n25)Footnote 25. In a discovery hearing in *OmniCare v. NCS HealthCare, Inc.*, the court held that "notes taken at

meetings, whether taken by directors or taken by someone acting as secretary, are properly discoverable." Transcript and Teleconference on Plaintiff's Motion to Compel at 13, *Omnicare v. NCS Healthcare, Inc.*, C.A. 19800 (Del. Ch. Oct. 16, 2003). With respect to draft minutes, the court also held that it is "appropriate to limit the review of ... drafts to the final minutes as they are approved by the board, except of course in circumstances where there are no final minutes and the exigencies of litigation require that the latest draft that is available be produced subject to whatever caveat may be necessary to its final authenticity." Transcript and Teleconference on Plaintiff's Motion to Compel at 14, *Omnicare v. NCS Healthcare, Inc.*, C.A. 19800 (Del. Ch. Oct. 16, 2003). In light of this decision, once final minutes are approved describing the events of a meeting, corporate secretaries may choose not to retain any notes they have taken either.

(n26)Footnote 26. Stored minutes should contain all the information provided to the board, including memos and PowerPoint presentations, in order to facilitate demonstration of the fact that the board's decisions were based on an adequate deliberative process, and to assist with director recollection. *See American Bar Association Committee on Corporate Laws, Corporate Director's Guidebook* 5th Ed. 46 (2008); Jaclyn Jaeger, *Board Liability in a Down Economy*, Compliance Week (Oct. 28, 2008).

(n27)Footnote 27. *See Corporate Governance Records: Solving the Three-Ring Binder Problem*, The Metropolitan Corporate Counsel, April 2006, Northeast Edition, Volume 14, No. 4, at 55.

(n28)Footnote 28. Maintaining the minutes electronically creates a record of changes and may therefore also decrease the chances for minutes tampering. *See Brendan Sheehan, Minutes of Integrity*, Corporate Secretary, June 2007. Further, some encourage the implementation and documentation of safeguards against tampering with minutes. *See Broc Romanek, Implement and Document Safeguards Against Tampering of Minutes*, at <http://www.thecorporatecounsel.net/member/FAQ/Minutes/043-minutes.htm>.



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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.05

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§ 14.05 The Chief Governance Officer

Although the position of chief governance officer is still a relatively new one,ⁿ¹ corporate scandals, changes in SRO listing standards and the adoption of the Sarbanes-Oxley Act have resulted in an increase in the number of executives whose main duty is to manage the entity's corporate governance regime.ⁿ² The once rare position of chief governance officer, long encouraged by the Society of Corporate Secretaries & Governance Professionals,ⁿ³ has become more popular.

A vigilant chief governance officer can identify potentially damaging governance issues and mitigate or prevent resulting damage to the company. The chief governance officer is the company's "in-house watch dog, or chief whistleblower, vigilantly overseeing the operations of the organization and protecting the interests of the directors and investors."ⁿ⁴ He or she should maintain a company's corporate governance regime and "act as a liaison with the board and the investing community."ⁿ⁵ Specifically, an effective corporate governance officer can perform the following functions:

- receive, document, organize and respond to concerns voiced by major shareholders and report those concerns to the board of directors, applicable committees and senior management, as appropriate;ⁿ⁶
- inform the company's directors of recent corporate governance trends and issues;ⁿ⁷
- act as a liaison to corporate governance rating agencies to help ensure the company's corporate governance rating is accurate;ⁿ⁸
- communicate with the underwriters of the company's directors and officers insurance policy; and
- assist in the recruitment of independent directors by helping to assess director independence.ⁿ⁹

A chief governance officer can assume many of the corporate governance-related responsibilities of various members of senior management.ⁿ¹⁰ In fact, a number of companies have designated their corporate secretary or other officers as the

chief governance officer.ⁿ¹¹ Whether or not a company requires a dedicated chief governance officer, however, depends on many variables, including its size, structure, internal culture, industry and the effectiveness of its existing governance policies. In many companies, the general counsel or the corporate secretary might take on the responsibilities of the position.ⁿ¹²

The person who does accept the responsibilities of chief governance officer should have sufficient time and resources to establish, monitor and evaluate the effectiveness of the company's governance objectives. To this end, a successful chief governance officer should have the support of the company's senior management team and should also be able to report directly to the board on matters involving management misconduct or corporate governance disruptions.ⁿ¹³

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Management Duties & Liabilities General Overview Business & Corporate Law Corporations Directors & Officers Scope of Authority General Overview Business & Corporate Law Corporations Governing Documents & Procedures General Overview

FOOTNOTES:

(n1)Footnote 1. The Conference Board, *Corporate Governance Best Practices* 29 (2003).

(n2)Footnote 2. *See* Gaston F. Ceron, *Staying Focused: Corporate governance may be everybody's responsibility; but at some companies, one person has more responsibility than others*, *Wall St. J.*, Feb. 24, 2003, at R7. Pfizer Inc. is generally credited with hiring the first corporate governance officer in 1992. As of May 2003, about 60 companies had corporate governance officers. Tamara Loomis, *Scandals Spur Increase in Governance Officers*, *Law Firm Practice Groups*, 229 *N.Y. L.J.*, col.3 (Apr. 24, 2003). Note that while the title of chief governance officer is often used to describe this position, many companies have policy review officers or ethics officers with the same functions and responsibilities.

(n3)Footnote 3. *See* Society of Corporate Secretaries & Governance Professionals website, at <http://www.governanceprofessionals.org>.

(n4)Footnote 4. Pamela Rohland, *Scandals Highlight Problems in Corporate Ethics Policies*, *E. Pa. Bus. J.*, Aug. 12, 2002, at 19. *See Corporate Secretary Perspective; American Society of Corporate Secretaries: Cutting Edge Resources for Corporate Governance in Today's Complex Business Environment*, *The Metropolitan Corporate Counsel*, April 2003.

(n5)Footnote 5. Tamara Loomis, *Scandals Spur Increase in Governance Officers*, *Law Firm Practice Groups*, 229 *N.Y. L.J.*, col.3 (Apr. 24, 2003). *See also* Terence J. Gallagher, *The Role of Corporate Governance Officers in M&A*, 5 *M&A Law*, 4, 14, Sept. 2001 (recommending that corporate governance officers foster strong relationships with major shareholders).

(n6)Footnote 6. The Conference Board, *Corporate Governance Handbook* 38 (2005).

(n7)Footnote 7. The Conference Board, *Corporate Governance Handbook* 38 (2005).

(n8)Footnote 8. The Conference Board, *Corporate Governance Handbook* 38 (2005).

(n9)Footnote 9. Richard H. Koppes and David W. Smith, *The Empowered Corporate Secretary, Directors and Boards*, Vol. 24, Issue 4 (June 22, 2000); June Eichbaum, Victoria Reese and Bruce Elvin, *The Corporate Governance Officer: A Human Capital Solution For Getting Back to Business* (2002).

(n10)Footnote 10. The Conference Board, *Corporate Governance Best Practices* 29 (2003). Note that while some

companies may choose to have one person perform both the roles of chief governance officer and chief compliance officer, the chief governance officer's position includes many responsibilities not covered by the chief compliance officer, including those described above.

(n11)Footnote 11. *See* The Conference Board, *Corporate Governance Handbook* 38 (2005)

(n12)Footnote 12. David Smith, President of the Society of Corporate Secretaries & Governance Professionals, believes corporate secretaries should be formally recognized in their companies as chief governance officer. *See Corporate Secretary Perspective; American Society of Corporate Secretaries: Cutting Edge Resources for Corporate Governance in Today's Complex Business Environment*, The Metropolitan Corporate Counsel, April 2003.

(n13)Footnote 13. *See* Cynthia A. Glassman, *Speech by SEC Commissioner: Sarbanes-Oxley and the Idea of "Good" Governance*, Address before the American Society of Corporate Secretaries (Sept. 27, 2002), at <http://www.sec.gov/news/speech/spch586.htm>.



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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.06

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§ 14.06 Compliance and Ethics Programs, the Compliance Function and the Chief Compliance Officer

[1] Compliance and Ethics Programs

Both as a legal and a practical matter, company-wide compliance and ethics programs "designed to prevent and detect criminal conduct" should be established and maintained.ⁿ¹ First, as explained further below, maintaining an effective compliance and ethics program can help a company defend itself against civil litigation by providing an evidentiary basis for the argument that the misconduct in question may only have been an anomaly. That being the case, not having such a program can help a plaintiff argue just the opposite - that the corporation should be liable for additional and perhaps punitive damages for its disregard of prudent and established behavior. Second, the adoption of a compliance and ethics program can have similar effects in the criminal context as well. For example, the United States Department of Justice takes into account the existence and effectiveness of a company's compliance program in evaluating whether to initiate a prosecution. This was initially articulated in an internal Department of Justice memorandum known as "Principles of Federal Prosecution of Business Organizations" (informally referred to as the "Thompson Memo") and is now contained in Title IX, Chapter 9.28.000 of the United States Attorney's Manual (the "Manual").ⁿ² The Manual lists nine factors prosecutors should consider in determining whether to charge a corporation.ⁿ³ Most notably, among those factors are "the existence and adequacy of the corporation's compliance program" and "the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one ...".ⁿ⁴ The importance of this mandate cannot be overstated. According to Chris Wray, a former Assistant Attorney General in charge of the Department of Justice's Criminal Division, "[t]he Thompson Memo [was] designed to shape and guide prosecutor's decisions in terms of whether or not to charge a company in the first instance."ⁿ⁵ Thus, the existence of an adequate compliance program may help a company avoid prosecution altogether. In the event prosecution cannot be avoided, additional incentives for the establishment of a compliance and ethics program continue to exist. Notably, in 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission adopted Organizational Sentencing Guidelines (the "Sentencing Guidelines").ⁿ⁶ The Sentencing Guidelines were substantially revised in 2004.ⁿ⁷ The Sentencing Guidelines set forth a uniform structure for companies to be sentenced for violations of federal criminal statutes. Though not binding on the courts, the Sentencing Guidelines also provide that the existence of an internal compliance and ethics program for the detection, prevention and reporting of criminal conduct in the workplace in accordance with seven requirements that should serve as the basis for a qualifying

compliance program can justify a substantial reduction in any applicable fine or penalty that may be assessed against the company.ⁿ⁸ In order to attain the leniency advised by the Sentencing Guidelines, a company must have a compliance and ethics program that includes, at a minimum, the following seven criteria:ⁿ⁹

1. *Standards and procedures must be established to prevent and detect criminal conduct.* These standards and procedures should be tailored to address a broad range of unacceptable conduct, including criminal conduct, and should be written and documented in employee handbooks, corporate policy manuals and internal auditing practices.

2. *The company's board of directors must be knowledgeable about the content and operation of the compliance and ethics program and must exercise "reasonable oversight" over the program and high level personnel (including directors and senior management) must be engaged to establish, implement and maintain the compliance and ethics program and must have "overall responsibility" for the program's effectiveness and "ensure" that the program is actually effective.* These individuals should focus on requiring compliance at all levels of the company, including the senior management team. The compliance program should also be subject to director oversight and periodic audit committee review and evaluation. Additionally, an individual should have operational responsibility for the program and report to the board on the program's "implementation and effectiveness".

3. *Candidates to whom substantial authority is delegated must be screened for past illegal or unethical conduct.* The company should also document its selection and screening procedures. These procedures can include background checks, interviews and employee questionnaires.

4. *Reasonable steps must be taken to train directors, officers, employees and agents with respect to compliance.* In enhancing the compliance-consciousness of its employees and directors, the compliance department must be careful to avoid a "here it is, read it, sign it, you're now responsible for complying with it" attitude.ⁿ¹⁰ Training should be vibrant and oriented toward helping employees and directors understand what the compliance program is, how it works and what is expected of them, and employees should be made to know the consequences of any misconduct as well as who to turn to with questions or evidence of misconduct.ⁿ¹¹ Directors should be trained using techniques that balance the requirements of the Sentencing Guidelines, the interests of the organization and directors' busy schedules. Possibilities include providing regular compliance briefings at board meetings and making employee ethics training classes available to directors.

5. *Reasonable steps must be taken so that the compliance and ethics program is followed, and to review the effectiveness of the program and to publicize a system whereby employees and agents may report or seek guidance regarding criminal conduct without fear of retaliation.* Monitoring and auditing systems can include periodic employee questionnaires, interviews and establishment of a reporting system whereby employees can report potential unlawful behavior to the compliance department (such as an anonymous telephone number or procedure for sending in tips). Note also, that pursuant to Section 301 of the Sarbanes-Oxley Act and the rules thereunder adopted by the SEC, audit committees are obligated to establish procedures for the receipt, retention and treatment of complaints and the anonymous submission by employees of concerns regarding questionable accounting or auditing matters.ⁿ¹²

6. *The compliance and ethics program must be promoted and enforced consistently through appropriate incentives and disciplinary measures.* In order for the compliance and ethics program to be effective, it must be applied uniformly to everyone, regardless of rank, seniority or position. The board and senior management team must also adhere to any compliance policy enforced by the compliance department, lest the employees may, as a whole, come to acknowledge the compliance policy as mere hypocrisy.ⁿ¹³ Formal, independent investigations of compliance breaches should be considered. In the event of a

violation, the compliance department can consider sanctions against the employee who engaged in the unlawful behavior, as well as the employees that should reasonably have known of such behavior.

7. *After criminal conduct is detected, reasonable steps must be taken to respond appropriately and to prevent further similar criminal conduct, including making necessary modifications to the program.*

According to the Sentencing Guidelines, in implementing a compliance and ethics program, the company must also "periodically assess the risk of criminal conduct and ... take appropriate steps to design, implement, or modify each requirement set forth [above] to reduce the risk of criminal conduct identified through this process" including assessing (i) the nature and seriousness of such criminal conduct, (ii) the likelihood that certain criminal conduct may occur in light of the company's business and (iii) the prior history of the company.ⁿ¹⁴

In addition to the potential sentencing leniency afforded by the Sentencing Reform Act and the Sentencing Guidelines themselves, in 1996 the Delaware Chancery Court provided a further incentive for companies to maintain compliance programs. In *In re Caremark International Inc. Derivative Litigation*, a patient health care provider pleaded guilty to paying referral fees to physicians in violation of federal law and was forced to pay two hundred fifty million dollars in fines.ⁿ¹⁵ Shareholders responded by filing a derivative suit, alleging that the directors had breached their duty of care by failing to supervise employees' conduct appropriately. The case ultimately settled.

In approving the settlement, the Delaware Chancery Court considered the scope of the board's responsibility "with respect to the organization and monitoring of the enterprise to assure that the corporation functions with the law to achieve its purposes."ⁿ¹⁶ The court noted that a board of directors has a duty to attempt in good faith to assure that a corporate information and reporting system (that the board concludes is adequate) exists, and further indicated that any rational director acting in good faith would take into account the opportunities for reduced penalties offered by the Sentencing Guidelines.ⁿ¹⁷ The Chancery Court's position should be heeded by boards of directors as plaintiffs may be quick to blame the board for violations which occur in the absence of an effective compliance and ethics program.

More recently, in *In re Abbott Laboratories Derivative Litigation*, plaintiff shareholders sued Abbott Laboratories' board of directors alleging they had breached their fiduciary duties by permitting safety violations of Food and Drug Administration rules.ⁿ¹⁸ Despite numerous warnings from the FDA, the directors of the company took no action, resulting in the largest civil fine imposed by the to that date FDA and the destruction and suspension of products worth two hundred fifty million dollars. Citing *Caremark*, the court stated that director liability may arise from the breach of the duty to exercise appropriate attention to potentially illegal corporate activities from "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss ... [A] sustained or systematic failure of the board to exercise oversight ... will establish the lack of good faith that is a necessary condition to [director] liability."ⁿ¹⁹

Companies should also take note of two additional cases, *United States v. Merck-Medco Managed Care, L.L.C.* and *Stone v. Ritter*. *United States v. Merck-Medco* indicates that failure to maintain an effective compliance and ethics program can lead to grave outcomes in litigation.ⁿ²⁰ Here, the Department of Justice brought a civil claim against Medco Health under the False Claims Act (FCA). Under the FCA, companies may be liable if they "knowingly" submit false claims paid with federal funds, or if they are found to have acted in "reckless disregard" or "deliberate ignorance" of the truth or falsity of the claims. Rather than attack Medco Health's knowledge of the false claims, the DOJ posited that Medco Health acted "with reckless disregard" of the truth or falsity of the information submitted to the United States because its board of directors and officers did not implement a proper compliance and ethics program. In enumerating the actions that Medco Health's board and officers failed to take, the DOJ largely tracked the seven criteria for an effective compliance and ethics program under the Sentencing Guidelines listed above. The court ultimately held that the failure to maintain an effective compliance program was sufficient to support the allegation that the company submitted false claims with "reckless disregard" under the FCA, despite the absence of any allegation that senior management knew the false claims were submitted.ⁿ²¹

In *Stone v. Ritter*, a case involving AmSouth Bancorporation, the company was subjected to \$50 million in fines and civil penalties for allegedly failing to fulfill its disclosure and reporting obligations under the Bank Secrecy Act and anti-money laundering rules with respect to activities of certain bank customers that were engaged in a "Ponzi" scheme that took place over the course of two years. The Delaware Supreme Court affirmed the Court of Chancery's decision to apply the so-called "*Caremark*" standard for assessing a director's personal liability for failing to act in good faith in discharging his or her oversight responsibilities. As the standard is described by the Supreme Court in this case, directors can be held liable based on alleged failures to satisfy their oversight responsibility only if:

(a) the directors utterly failed to implement any reporting or information systems or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. n22

Before applying this standard to the facts, the Supreme Court noted that because most of the decisions a corporation makes (through its human agents) are not the subject of director attention, "a claim that directors are subject to personal liability for employee failures is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." n23 Because AmSouth had systems in place to deter and detect such suspicious activity, the Delaware Supreme Court declined plaintiffs' invitation "to equate a bad outcome with bad faith" and concluded that the Court of Chancery was correct in dismissing plaintiffs' claims. Directors should take some comfort in knowing that Delaware law imposes a heavy burden on plaintiffs seeking to impose personal liability on corporate directors in these types of circumstances.

In a 2007 decision, the Delaware Chancery Court similarly refused to equate the occurrence of illegal behavior with *per se* deficient internal controls and dismissed plaintiff's complaint for failing to plead relevant facts with particularity, again showing the heavy burden on plaintiffs seeking to impose personal liability on corporate directors.n24

In addition to the incentives offered by reducing the company's exposure to various legal actions, an effective compliance program also offers more direct financial benefits due to the growing number of organizations that offer various forms of ratings and rankings to assess a company's corporate governance.n25 For example, Standard and Poor's ("S&P") will, at a company's request, perform an extensive review of the company's corporate governance practices, which may result in a rating modification that can act as either a positive or negative sign to investors.n26 Buttressing the contention that good governance can provide a financial boost to a company, an S&P white paper found that greater corporate transparency and disclosure were correlated with lower market risk and higher stock valuation.n27 These ratings can also greatly impact day-to-day operations of a company, as a poor rating often mobilizes dissident shareholders to pool resources and enact shareholder proposals that otherwise could not have garnered sufficient support.n28

In light of the decisions described above taken as a whole, the Sentencing Guidelines, and Sarbanes-Oxley Act Sections 301 (relating to whistle blowing procedures), 406 (relating to codes of ethics) and 806 (relating to prohibitions against retaliations against whistle blowers), as well as self-regulatory organization rules that relate to codes of conduct and ethics and the audit committee's responsibility to oversee legal and regulatory requirements and discuss policies with respect to risk assessment and management and the increasing consideration of compliance programs afforded by ratings agencies, companies and their compliance officers should pay close attention to the effectiveness of their compliance and ethics programs and review and update these programs periodically.

[2] The Compliance Function and the Chief Compliance Officer

The task of monitoring and enforcing a company's compliance program and implementing legal and regulatory

compliance generally can either be centralized or dispersed throughout the company, and can involve various executives, employees, directors and resources. Many companies have opted to designate a single chief compliance officer, who may be the general counsel, the head of internal audit, the corporate secretary or, depending on the size and needs of the company, an officer whose job function is wholly dedicated to corporate compliance.ⁿ²⁹ Other actors can support the compliance officer in their implementation of the company's compliance function. For example, corporate controllers assist with regulatory compliance and SEC filing requirements and the internal auditors and the head of internal audit monitor the company's accounting policies and internal control over financial reporting.ⁿ³⁰ Once the compliance officer is designated, companies should consider to whom the compliance officer reports. While there is no one correct answer, compliance officers often report directly to a senior member of management, such as the CEO or the general counsel, or directly to the audit committee. In any event, the compliance officer should have open to it a direct channel of communication to the audit committee. Many companies have also established an internal management committee to oversee compliance. Depending upon the company's size, this committee may consist of the compliance officer (if there is such a designated officer), general counsel, CFO, head of human resources and the head of internal audit.

However the company ultimately establishes its compliance function, in order for those responsible for corporate compliance to deter wrongdoing effectively and enforce their company's compliance and ethics program, they must have adequate resources to draw from. Those involved in monitoring compliance should have appropriate training, and compliance teams should be staffed with motivated, qualified and career oriented employees. Companies should communicate to their employees the message that participation in the compliance function offers the chance not only to gain an understanding of the company and the industry, but for increased opportunities within the corporation.

Those implementing the compliance function should also have the authority and backing of their company's senior management team and be authorized to sanction, and even fire employees who engage in conduct that violates the company's compliance program or broader code of conduct.ⁿ³¹ A compliance function being carried out by those following a clear mandate set by senior management or the board of directors is more likely to be effective.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewCriminal Law & ProcedureCriminal OffensesFraudFraud Against the GovernmentFalse ClaimsPenaltiesCriminal Law & ProcedureSentencingGuidelinesGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. *See* USSG § 8B2.1 Commentary Application Note 1. Compliance and ethics programs should be established as part of a broader risk management program. In September 2004, COSO released Enterprise Risk Management-Integrated Framework, which describes the components and principles of enterprise risk management for companies to identify and avoid risks. According to COSO, the underlying premise of enterprise risk management is that the purpose of entities is to provide value to shareholders-in so doing, management must determine what level of uncertainty the entity can accept. Enterprise Risk Management is defined as "a process, effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives." Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management-Integrated Framework, Executive Summary (Sep. 2004). Certain types of companies, such as brokerage firms, have long been required to have compliance programs. Section 15(b)(4)(E) of the 1934 Act authorizes disciplinary proceedings against brokerage firms (and associated individuals) for failing to

reasonably supervise those who commit 1934 Act violations. A defense is available, however, if the brokerage firm can show that a reasonable compliance program had been implemented. Additionally, in December 2003, the SEC adopted rules which require investment companies and investment advisers to adopt and implement compliance programs. *See* SEC Release IA-2204 (Dec. 17, 2003). Section 406 of the Sarbanes-Oxley Act and the SEC's related rules require companies to disclose whether they have adopted codes of ethics covering the CEO and senior financial officers. Further, Section 303A.10 of the NYSE Listed Company Manual requires companies with securities listed on the NYSE to adopt and disclose a code of business conduct and ethics for directors, officers and employees containing compliance standards and procedures. *See* NYSE Listed Company Manual § 303A.10. Compliance and codes of corporate conduct are discussed in Chapter 13 *above*. Nasdaq's Marketplace Rules contain a similar provision. *See* NASD Rule 5610.

(n2)Footnote 2. *See* U.S. Attorney's Manual ch. 9.28.000 (2008), at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm; *Principles of Federal Prosecution of Business Organizations* (at www.usdoj.gov/dag/cftf/corporate_guidelines.htm).

(n3)Footnote 3. In summary, the factors listed in the Manual and the Thompson Memo are: (1) the nature and seriousness of the offense; (2) the pervasiveness of the wrongdoing; (3) the company's history of similar conduct; (4) the company's timely and voluntary disclosure of wrongdoing and willingness to cooperate in the investigation (including, under certain circumstances, the waiver of attorney-client privilege and work product protection); (5) the existence and adequacy of the company's pre-existing compliance program; (6) the remedial actions taken by the company, including any efforts to implement an effective corporate compliance program or to improve an existing one; (7) the collateral consequences arising from the prosecution; (8) the adequacy of the prosecution of individuals for the company's malfeasance; and (9) the adequacy of civil or regulatory enforcement. *See* U.S. Attorney's Manual ch. 9.28.000 (2008), at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm; A memorandum from Deputy Attorney General Paul, J. McNulty also entitled "Principles of Federal Prosecution of Business Organizations" (informally referred to as the "McNulty Memo") and announced by the Department of Justice on December 12, 2006 superseded the Thompson Memo. Though the factors listed above remained in tact, the new policy made changes to the circumstances under which attorney-client communications should be sought. *See Principles of Federal Prosecution of Business Organizations* (available at www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf). The McNulty memo was then superseded by Ch. 9.28.000 of the Manual on August 28, 2008, which further sought to clarify how issues regarding attorney-client privilege were addressed.

(n4)Footnote 4. *See* U.S. Attorney's Manual ch. 9.28.000 (2008), at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm.

(n5)Footnote 5. *The Justice Department's Rational Approach to Deterring Corporate Crime*, The Metropolitan Corporate Counsel: Special Section: Project: Corporate Counsel Part I (Unintended Consequences) at 35 (July 2005). Similarly, the SEC has also noted that the state of an organization's compliance program will be a factor in deciding whether or not to bring an enforcement action, or may result in reduced penalties if an action is ultimately commenced. Among the factors listed by the SEC related to corporate compliance are: 1) What compliance procedures were in place to prevent the misconduct now uncovered?; 2) Why did those procedures fail to stop or inhibit the wrongful conduct?; and 3) How long after discovery of the misconduct did it take to implement an effective response? *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, 1934 Act Release No. 44,969 (Oct. 23, 2001). [Project Corporate Counsel Part I (Unintended Consequences)* *The Justice Department's Rational Approach to Deterring Corporate Crime*, The Metropolitan Corporate Counsel, July 2005, Northeast Edition, Special Section, at 35.

(n6)Footnote 6. *See* USSG § 8B2.1.

(n7)Footnote 7. Pursuant to Section 805(a) of the Sarbanes-Oxley Act, on April 30, 2004, the United States Sentencing Commission delivered to Congress amendments to the Sentencing Guidelines, including revisions to the criteria a company must follow in order to have an effective compliance program. The amendments took effect on

November 1, 2004. The criteria, the amendments and the Sentencing Guidelines are discussed in further detail in § 13.02[2][b] above and the amended guidelines are reproduced in Appendix 13-A to Chapter 13 above.

(n8)Footnote 8. On June 24, 2004, the United States Supreme Court cast doubt on the constitutionality of the Sentencing Guidelines in holding that the state of Washington's sentencing guidelines were unconstitutional because they permitted a judge, and not a jury, to consider factors that could increase a defendant's criminal penalty. See *Blakely v. Washington*, 124 S. Ct. 2531 (2004). The decision did not address the constitutionality of the Federal Sentencing Guidelines. On January 12, 2005, however, the United States Supreme Court answered the constitutionality question posed in *Blakely*, and declared the Sentencing Guidelines to be in violation of the *Sixth Amendment* right to a jury trial. See *United States v. Booker* 543 U.S. 220, 125 S. Ct. 738, 160 L. Ed. 2d 621 (2005). By severing two key provisions of the Sentencing Guidelines, the Supreme Court, in effect, transformed the guidelines from a binding system to an advisory system. Federal courts may now *choose* to take the factors set forth in the Sentencing Guidelines into effect when sentencing criminals, but are not obligated to do so. In the majority opinion, Justice Breyer noted that the body of federal sentencing appellate law delivered by federal courts since the Sentencing Guidelines were adopted remains in effect to guide the courts. While the *Booker* and *Fanfan* decisions applied to individuals, it is likely that they will be applied to organizations as well in the future (though it remains unclear whether a corporation has a *Sixth Amendment* right to a jury trial). Notwithstanding, companies should continue to heed the definition of an effective compliance and ethics program, as courts are likely to continue to consider the guidelines when evaluating the effectiveness of corporate compliance and ethics programs and the SEC, Department of Justice and other government agencies are likely to consider them when determining whether action is warranted.

(n9)Footnote 9. See USSG § 8B2.1.

(n10)Footnote 10. See Lynn Pollan, *Steps for Starting an Effective Compliance Program*, 1177 PLI/Corp 385, 407 (2000).

(n11)Footnote 11. See Lynn Pollan, *Steps for Starting an Effective Compliance Program*, 1177 PLI/Corp 385, 407 (2000).

(n12)Footnote 12. See Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1 (2007). See also 1934 Act Rule 10A-3, 17 CFR § 240.10a-3 (2009). The responsibilities of the audit committee are discussed in Chapter 9 above.

(n13)Footnote 13. Note that pursuant to Section 303A.10 of the NYSE Listed Company Manual, companies with securities listed on the NYSE must adopt a code of conduct and ethics for all directors, officers and employees.

(n14)Footnote 14. USSG § 8B2.1(c) Commentary.

(n15)Footnote 15. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

(n16)Footnote 16. *Caremark*, 698 A.2d at 969.

(n17)Footnote 17. See *Caremark*, 698 A.2d at 969.

(n18)Footnote 18. See *In re Abbott Labs. Derivative Litig.*, 325 F.3d 795 (7th Cir. 2002).

(n19)Footnote 19. *Abbott Labs.*, 325 F.3d at 808 (quoting *Caremark*, 698 A.2d at 967).

(n20)Footnote 20. See *United States v. Merck-Medco Managed Care, L.L.C.*, 336 F.Supp.2d 430 (E.D.Pa. 2004) and *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

(n21)Footnote 21. See *United States v. Merck-Medco Managed Care, L.L.C.*, 336 F.Supp.2d 430, 440-441 (E.D.Pa. 2004).

(n22)Footnote 22. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) .

(n23)Footnote 23. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 372 (Del. 2006) .

(n24)Footnote 24. *See Desimone v. Barrows*, 924 A.2d 908, 940 (Del. Ch. 2007) .

(n25)Footnote 25. *See* Dana H. Freyer, *Guidelines for Directors' Ethics and Compliance Program Oversight Responsibilities*, 14462 PLI/Corp 693, 698-99 (2008).

(n26)Footnote 26. *See* Ben White, *Bond-Rating Firms Get Into Governance; Analysts Assess Corporate Practices*, Washington Post, Feb. 15, 2003 at E01.

(n27)Footnote 27. *See* William Baue, *Corporate Governance Now Rated by Mainstream Investment Research Firms* (Oct. 25, 2002) at <http://www.socialfunds.com/news/print.cgi?sfArticleId=954>.

(n28)Footnote 28. *See* William F. Coffin and Mark Collinson, *The Rise of Corporate Governance Ratings* (2005) at http://www.ccgir.com/ccgir/white_papers/pdf/Governance%20Rating%20Services%20121505.pdf.

(n29)Footnote 29. The general counsel has an interest in helping his or her company comply with laws and regulatory requirements (and to the extent he or she becomes aware of material violations, has additional obligations pursuant to Section 307 of the Sarbanes-Oxley Act as discussed in § 14.07[3] below).

(n30)Footnote 30. *See* Venrice R. Palmer, *Empowering and Protecting the Corporate Ethics and Compliance Officer*, 1165 PLI/Corp 251, 258 (2000).

(n31)Footnote 31. *See* John H. Walsh, *Right The First Time: Regulation, Quality and Preventive Compliance in the Securities Industry*, 1997 Colum. Bus. L. Rev. 165, 193 (1997).



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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.07

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§ 14.07 The General Counsel

[1] The Role of Lawyers

As a general matter, the company's inside and outside counsel act as advisors to the board of directors and senior management and often participate in the structuring, negotiation and documentation of business transactions. In addition to carrying out these responsibilities, an effective corporate attorney also counsels the board of directors in carrying out its responsibilities. "[A] prudent corporate governance program should call upon lawyers-notably general counsel-to assist in the design and maintenance of the corporation's procedures for promoting legal compliance."¹

The attorney's role in establishing and maintaining a system of sound corporate governance differs from that of the outside auditor, the company's other retained professional. While the outside auditor expects that its audit report may be relied on by the users of the audited financial statements and must maintain its independence from the corporation and its management, lawyers are trained advocates that owe their loyalty to the corporation.² Corporate attorneys must remain cognizant of this obligation to the company despite the fact that their continued employment rests in the hands of senior management. As stated in the Report of the ABA Task Force on Corporate Responsibility:

[L]awyers for the public corporation must bear in mind that their responsibility is to the corporation, and not to the corporate directors, officers or other agents with whom they necessarily communicate in representing the corporation. [Attorneys should understand the business goals of the executive officers of their corporate clients, but] at the same time retain the professional detachment that allows them to recognize and point out issues of legal compliance, even at the risk of being perceived as unduly pessimistic or obstructive of the business plans sought by the corporation's executive officers. There are times, moreover, when the corporate lawyer must recognize that his or her own independence may be compromised by relationships with senior executive officers; at such times, the lawyer's responsibility may require him or her to assure that the corporate client retains other counsel who can exercise the requisite professional detachment.³

"Preventive lawyering," the concept that legal, regulatory and governance problems can be avoided through monitoring and early detection, has long encouraged corporations to establish counsel-structured compliance programs dedicated to

early detection.ⁿ⁴ In order for the company's general counsel to employ early detection safeguards effectively, CEOs and other members of the senior management team should implement procedures designed to help critical information flow through to the general counsel. The general counsel can also gain access to critical information by participating in the company's board and committee meetings and interacting with management on a real-time basis. Of course, in order to review and process the information collected as a result of these efforts appropriately, the general counsel must have adequate staff assistance.

Though inside counsel is not required to certify as to periodic reports, he or she should advise the CEO and CFO as to the purposes and effects of the certifications required by the Sarbanes-Oxley Act as well as the penalties for certifying falsely. Inside counsel should also participate in the establishment, maintenance and evaluation of internal control over financial reporting and disclosure controls and procedures. Ideally, the general counsel's (or other in-house attorney's) strong knowledge of SEC rules and regulations and exposure to critical information about the company will put him or her in a unique position to determine the materiality of information to be disclosed in public filings.

[2] The General Counsel's Role in Maintaining Good Corporate Governance

From a governance perspective, the general counsel is, in part, responsible for bringing legal compliance matters to the attention of appropriate authorities within the corporation. Among other things, the general counsel is responsible for overseeing the company's reporting obligations, assessing the company's adherence to applicable laws and regulations and evaluating employee conduct. In order for the general counsel to fulfill these responsibilities, he or she should closely monitor the flow of information within the corporation. As such, companies should consider the following:

- *The general counsel should communicate regularly with senior management.* Communicating regularly with senior management will expose the general counsel to business strategies, governance decisions and discussions regarding financial reporting, internal control over financial reporting and disclosure controls and procedures. Ongoing communication will also put the general counsel in a better position to offer suggestions as issues arise.
- *Independent directors should meet regularly with the general counsel.* Allowing the general counsel to meet regularly with the independent directors gives the general counsel an opportunity to update them on actions taken by senior management.ⁿ⁵ Ritualizing meetings and communications between the general counsel and the independent directors is also likely to improve compliance with the attorney conduct rules adopted pursuant to Section 307 of the Sarbanes-Oxley Act, described in § 14.07[3] below. Regular meetings facilitate fluid interaction by making such reports part of a program of ongoing communication. The mere fact that the general counsel is expected to make such routine reports could even dissuade senior executives from acting in a potentially violative manner to begin with.
- *The general counsel should have an ongoing relationship with outside counsel.* The general counsel should have a direct and ongoing relationship with the company's outside counsel and encourage these attorneys to advise him or her as to any existing or pending violations of law and legal developments. As discussed in § 14.07[3] below, the rules adopted pursuant to Section 307 of the Sarbanes-Oxley Act require certain in-house and outside attorneys to report evidence of material violations of law to an issuer's chief legal officer, chief executive officer and board of directors.ⁿ⁶ If outside counsel alerts the general counsel to an existing or potential violation, the general counsel should in turn take other appropriate remedial action or communicate the discovery to higher corporate authorities. As noted by the ABA Task Force, a regular line of communication will "make subsequent communications between outside counsel and general counsel less an insurrection and more of a routine practice, enhancing the likelihood that information concerning potential corporate misconduct will flow to persons (notably the general counsel) in a position to investigate and take action to prevent or rectify the problem."ⁿ⁷

■ *The company should understand the general counsel's role.* While the general counsel often acts as the trusted advisor to senior management and the CEO, an understanding should be established with key corporate officers that the general counsel's (like outside counsel's) ultimate duties lie with the corporation as represented by the board of directors, not with management or individual officers of the corporation.

[3] The SEC Attorney Conduct Rules

[a] Overview

The attorney's role in its client's or employer's corporate governance system generally has been governed by a combination of self-regulation and unrestrictive state law and ethical rules. For the most part, attorneys have been free to communicate with and within their clients as much or as little as required by their engagement and their client's needs.ⁿ⁸ To the extent that attorney conduct and communication has been subject to regulation, that regulation has generally been a product of state law and bar associations, rather than federal law and federal rule making. Of course, the SEC has, in the past, brought administrative proceedings against attorneys for "unethical conduct". These proceedings were brought on the theory that lawyers act as "gatekeepers" to the securities markets. For example, in the 1981 case, *Carter v. Johnson*, the SEC went so far as to interpret Rule 102(e) of its Rules of Practice as requiring lawyers who learn of "substantial and continuing" disclosure violations by their clients to "take prompt steps to end the client's noncompliance."ⁿ⁹ The following year, however, the SEC retreated from this interpretation, announcing that "[w]ith respect to attorneys, the Commission generally has not sought to develop or apply independent standards of professional conduct. The great majority of Rule 102(e) proceedings against attorneys involve allegations of violations of the law (not of professional standards); thus, the Commission, as a matter of policy, generally refrains from using its administrative forum to conduct *de novo* determinations of the professional obligations of attorneys."ⁿ¹⁰

Notwithstanding prior interpretations of Rule 102(e), with the enactment of Section 307 of the Sarbanes-Oxley Act, the SEC became officially responsible for developing rules governing professional conduct for lawyers "appearing and practicing" before the SEC. Section 307, entitled "Rules of Professional Responsibility for Attorneys," specifically directed the SEC to issue rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the [SEC] in any way in the representation of issuers, including a rule ... requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation" by an issuer-client or its agent "up the ladder" within the client's ranks.ⁿ¹¹ By giving the SEC direct authority to promulgate standards of conduct for attorneys, Section 307 imposed federal regulation upon attorney conduct—an area that, for the most part, had been the domain of state courts and bar associations. As a result, lawyers who appear and practice before the SEC now may be subject to discipline both by the SEC *and* by the states, at least to the extent that state disciplinary proceedings are not inconsistent with Section 307 and related SEC rules (discussed below).ⁿ¹²

In January 2003 the SEC responded to Congress's mandate by adopting initial final rules implementing Section 307. The rules were published in a new Part 205 of Title 17, Chapter II of the Code of Federal Regulations. The standards contained in the rules were meant to supplement standards of the state in which an attorney is admitted or practices and are not intended to limit states from imposing additional obligations on attorneys that are not inconsistent with the rules adopted by the SEC.ⁿ¹³ The rules adopted by the SEC became effective on August 5, 2003.ⁿ¹⁴

The rules require attorneysⁿ¹⁵ "appearing and practicing"ⁿ¹⁶ before the SEC "in the representation of an issuer"ⁿ¹⁷ to report evidence of a material violationⁿ¹⁸ of securities law, breach of fiduciary dutyⁿ¹⁹ or similar material violation by the issuer or its agent "up the ladder" to the issuer's chief legal officer (CLO), who is usually the general counsel, or to both the CLO and the CEO. If the CLO or CEO does not appropriately respond to the evidence presented, the attorney must report the evidence to the issuer's audit committee, another committee composed solely of directors who are not employed by the issuer, or the full board of directors.ⁿ²⁰

[b] "Appearing and Practicing" Before the SEC

The SEC attorney conduct rules apply to attorneys "appearing and practicing" before the SEC in the representation of issuers. Part 205.2(a)(1) defines "appearing and practicing" as follows:ⁿ²¹

- transacting any business with the SEC, including communications in any form;
- representing an issuer in an SEC administrative proceeding or in connection with an SEC investigation, inquiry, information request or subpoena;
- providing advice with respect to the federal securities laws or the SEC's rules and regulations under such laws, regarding any document that the attorney has notice will be filed with or submitted to (or incorporated into any document that will be filed with or submitted to) the SEC; or
- advising an issuer as to whether information or a statement, opinion or other writing is required (under the federal securities laws or the SEC's rules or regulations thereunder) to be filed with or submitted to (or incorporated into any document that will be filed with or submitted to) the SEC.

Though the rules cover only those attorneys who "appear and practice" before the SEC in the representation of an issuer, it may in many cases be difficult to determine whether an attorney is "appearing and practicing" before the SEC. For example, the term could be read to include (among others) attorneys who work on contracts that subsequently are appended to SEC filings, attorneys who represent individual officers, directors or employees at the request of the company, attorneys who provide backup certifications to management and attorneys who respond to audit inquiries. Because the definition raises difficult interpretive questions, many companies have chosen to make their reporting policies applicable to all attorneys, with a supervisory attorney or the CLO deciding whether a particular reporting attorney is covered by the rules. Attorneys retained or directed by an issuer to investigate evidence of a material violation also are deemed to be "appearing and practicing" before the SEC under the rules.ⁿ²² As discussed in further detail below,ⁿ²³ however, special reporting rules apply to these attorneys.

The rules apply only where an attorney is providing legal services to an issuer within the context of an attorney-client relationship. This means, for example, that attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the SEC, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship, are not covered by the rules. The rules also do not apply to non-appearing foreign attorneys.ⁿ²⁴ A non-appearing foreign attorney is defined as an attorney who: (1) is admitted to practice law in a jurisdiction outside the United States; (2) does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws; and (3) either conducts activities that would constitute appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States, or is appearing and practicing before the SEC only in consultation with U.S. counsel.ⁿ²⁵ The rules also provide that an attorney practicing outside the United States will not be required to comply with the rules to the extent compliance is prohibited by applicable foreign law.ⁿ²⁶

[c] Duty to Report Material Violations

An attorney's reporting obligations are triggered if he or she is appearing and practicing before the SEC in the representation of an issuer and becomes aware of evidence of a material violation by the issuer or by an officer, director, employee or agent of the issuer.ⁿ²⁷ If the attorney becomes aware of such evidence, he or she must report the evidence to the issuer's chief legal officer or to both the CLO and chief executive officer (or to officers with equivalent positions).ⁿ²⁸ If the attorney reasonably believes it would be futile to report to the CLO and CEO, the attorney may report the evidence to the issuer's audit committee, another board committee consisting solely of directors not employed by the issuer, or the full board of directors.ⁿ²⁹

The rules define a "material violation" as a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.ⁿ³⁰ The rules set forth an objective standard for what evidence will trigger an attorney's reporting obligations. A reporting obligation is only triggered if the attorney has credible evidence, based upon which it would be unreasonable under the circumstances for a prudent and competent attorney not to conclude it is reasonably likely that a material violation either has occurred, is ongoing or is about to occur.ⁿ³¹

The rules provide that attorneys are not obligated to report evidence of material violations in the following three situations:

- if (i) the attorney was retained or directed by the issuer's CLO to investigate evidence of a material violation, (ii) the attorney reports the results of the investigation to the CLO and (iii) the CLO reports the results of the investigation to the issuer's board of directors, a committee consisting solely of directors who are not employed by the issuer or a qualified legal compliance committee (QLCC);ⁿ³²
- if (i) the attorney was retained or directed by the CLO to assert a colorable defense on behalf of the issuer (or the issuer's agent, as applicable) in an investigation or judicial or administrative proceeding relating to such evidence and (ii) the CLO provides reasonable and timely reports on the progress of that proceeding to the issuer's board of directors, a committee consisting solely of directors who are not employed by the issuer, or a QLCC;ⁿ³³ or
- if the attorney was retained or directed by a QLCC either (i) to investigate evidence of a material violation or (ii) to assert a colorable defense on behalf of the issuer (or the issuer's agent) in any investigation or judicial or administrative proceeding relating to such evidence.ⁿ³⁴

[d] Chief Legal Officer

Upon receiving evidence of a material violation, the chief legal officer must cause an inquiry into the evidence as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing or is about to occur.ⁿ³⁵ If the CLO determines that no material violation has occurred, is ongoing, or is about to occur, he or she must notify the reporting attorney and advise him or her of the basis for that determination.ⁿ³⁶ On the other hand, if the CLO cannot make this determination, he or she must "take all reasonable steps to cause the issuer to adopt an appropriate response" and advise the reporting attorney thereof.ⁿ³⁷ Alternatively, the CLO may refer the reported evidence to a QLCC if the QLCC was established prior to the report.ⁿ³⁸

[e] Appropriate Response

If the reporting attorney reasonably believes the CLO or CEO (if applicable) has provided an "appropriate response" to the reported evidence within a reasonable time, the attorney has no further reporting obligations under the rules. If the attorney does *not* believe that the CLO or CEO has provided an appropriate response, however, then the attorney must report the evidence to: (i) the issuer's audit committee; (ii) another board committee consisting solely of directors who are not employed by the issuer; or (iii) the issuer's board of directors (if the board does not have a committee consisting solely of directors who are not employed by the issuer).ⁿ³⁹ Under the rules, an "appropriate response" is a response that leads the reporting attorney to form a reasonable belief that:

- no material violation has occurred, is ongoing or is about to occur;
- the issuer has adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and

to remedy or otherwise appropriately address any material violation that has already occurred and minimize the likelihood of its recurrence; or

- the issuer, with the consent of its board of directors, a committee of directors not employed by the issuer, or the QLCC, has retained or directed an attorney to review the reported evidence and has either (i) substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence, or (ii) been advised that such attorney may, consistent with that attorney's professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's agent) in any investigation or judicial or administrative proceeding relating to the reported evidence.ⁿ⁴⁰

In determining whether he or she can reasonably believe that a response is appropriate, the reporting attorney may consider the amount and weight of evidence of a material violation, the severity of the apparent material violation, and the scope of the investigation into the report.ⁿ⁴¹

Again, if the reporting attorney does not reasonably believe the CLO or CEO has provided an appropriate response to evidence of a material violation within a reasonable time, the attorney is required to report the evidence to the issuer's audit committee, another board committee composed solely of directors who are not employed by the issuer or the board of directors. If, after reporting the evidence to the audit committee, other committee or the board, the attorney still does not reasonably believe that the issuer has provided an appropriate response within a reasonable time, the attorney must explain the reasons for this belief to the issuer's CLO, CEO and directors to whom the attorney reported the evidence.ⁿ⁴²

The rules set forth alternative reporting procedures for issuers that have established a QLCC.ⁿ⁴³ If an attorney becomes aware of evidence of a material violation by the issuer (or an officer, director, employee or agent of the issuer), the attorney may, as an alternative to the procedures listed above, report such evidence to a QLCC, if the issuer previously formed such a committee.ⁿ⁴⁴ An attorney who reports evidence of a material violation to a QLCC has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence.ⁿ⁴⁵ In addition, as noted above, the rules permit the CLO to refer a report of evidence of a material violation to a previously established QLCC, rather than causing an inquiry into the evidence, and inform the reporting attorney that the report has been referred to the QLCC.ⁿ⁴⁶ After such a referral, the QLCC becomes responsible for responding to the reported evidence.ⁿ⁴⁷

[f] Qualified Legal Compliance Committee

As mentioned above, the rules authorize, but do not require, an issuer to create a qualified legal compliance committee to provide an alternative procedure for reporting evidence of material violations.ⁿ⁴⁸ A QLCC is defined as a committee of an issuer (which also may be the issuer's audit or other committee) that:

- consists of at least one member of the issuer's audit committee (or an equivalent committee of independent directors if the issuer has no audit committee) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer (and who are not "interested persons"ⁿ⁴⁹ in the case of a registered investment company); and
- has adopted written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation.ⁿ⁵⁰

To meet the regulatory definition of a QLCC, such a committee must also have been established by the issuer's board of directors, with the authority and responsibility to:

- inform the issuer's CLO and CEO of any report of evidence of a material violation;ⁿ⁵¹
- determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer (or its officers, directors, employees or agents) and, if it determines an investigation is necessary or appropriate, to: (a) notify the audit committee or full board of directors; (b) initiate an investigation, which may be conducted either by the CLO or outside attorneys; and (c) retain such additional expert personnel as the committee deems necessary;ⁿ⁵²
- at the conclusion of any such investigation to: (a) recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and (b) inform the CLO, CEO and board of directors of the results of any such investigation and the appropriate remedial measures to be adopted;ⁿ⁵³ and
- acting by majority vote, to take all other appropriate action, including the authority to notify the SEC in the event that the issuer fails in any material respect to implement an appropriate response that the QLCC has recommended the issuer to take.ⁿ⁵⁴

Although the QLCC must have the authority and responsibility to recommend that an issuer implement an appropriate response, the QLCC is not required to direct the board of directors to take such action.ⁿ⁵⁵

[g] Disclosure of Confidential Information

The rules adopted pursuant to Section 307 permit attorneys covered by the rules to disclose issuer confidences under specified circumstances. First, any report made by an attorney under the rules (and any response to such a report) may be used by the attorney in connection with any investigation, proceeding or litigation in which the attorney's compliance with the rules is in issue.ⁿ⁵⁶ Second, an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

- to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
- to prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury or an act that is likely to perpetrate a fraud upon the SEC; or
- to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.ⁿ⁵⁷

Although disclosure of confidential information is permitted in these situations by the SEC rules, attorneys should recognize that such disclosure may violate state and local ethics standards. The SEC rules provide that an attorney who complies in good faith with the rules will not be subject to discipline or otherwise liable under inconsistent standards imposed by state or local jurisdictions in which the attorney is admitted or practices. The rules state explicitly that "[w]here the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern."ⁿ⁵⁸ . Notwithstanding this provision, however, some state bar associations have indicated that they do not believe the SEC has the authority to preempt their rules governing the attorney-client privilege and protection of client confidences. As a result, an attorney who reveals client confidences under the SEC rules runs the risk of discipline on the state or local level.ⁿ⁵⁹

[h] Supervisory and Subordinate Attorneys

Under the rules, a "supervisory attorney" is an attorney who supervises or directs another attorney who is appearing and practicing before the SEC in the representation of an issuer,ⁿ⁶⁰ and a "subordinate attorney" is an attorney who appears and practices before the SEC in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision of the issuer's chief legal officer or equivalent).ⁿ⁶¹

The rules require a supervisory attorney to make reasonable efforts to ensure that any subordinate attorneys under his or her supervision or direction adhere to the rules.ⁿ⁶² In addition, a supervisory attorney is responsible for complying with the rules' reporting requirements when a subordinate attorney reports evidence of a material violation to him or her.ⁿ⁶³

Subordinate attorneys are required to comply with the rules notwithstanding the fact that they act at the direction or under the supervision of another person.ⁿ⁶⁴ However, a subordinate attorney is deemed to have complied with the reporting requirements if he or she reports evidence of a material violation to his or her supervising attorney.ⁿ⁶⁵

[i] Penalties

Any attorney who violates Part 205 (the rules adopted under Section 307) subjects himself or herself to all civil penalties and remedies for a violation of the federal securities laws available to the SEC.ⁿ⁶⁶ The attorney is also subject to the disciplinary authority of the SEC, regardless of whether the attorney might also be subject to discipline for the same conduct in a jurisdiction where he or she is admitted or practices.ⁿ⁶⁷ However, as noted above, the rules provide that attorneys who comply in good faith will not be subject to discipline or otherwise liable under inconsistent standards imposed by any jurisdiction where the attorney is admitted or practices.ⁿ⁶⁸

The rules also provide a safe harbor to protect attorneys, law firms and issuers from private liability for violations.ⁿ⁶⁹ In this regard, the rules state that: (1) the SEC has the exclusive authority to enforce compliance with Part 205, and (2) Part 205 does not create a private right of action against any attorney, law firm or issuer based upon compliance or non-compliance with its provisions.ⁿ⁷⁰ Notwithstanding this safe harbor, however, it is possible that the plaintiffs' bar could introduce compliance or non-compliance with the rules as evidence in actions against the issuer (for example, alleging that the issuer was informed by its attorneys of a securities law violation but failed to act). In addition, the rules do not expressly preclude plaintiffs from arguing that the rules establish a standard of care for attorneys, and that attorneys who fail to fulfill their reporting obligations are breaching a duty of care to their clients.

[j] Responding to the Up the Ladder Rules

The SEC rules adopted pursuant to Section 307 of the Sarbanes-Oxley Act place significant burdens on issuers and their officers and attorneys. Companies should consider taking the following steps to facilitate compliance with the rules:

- *Discuss the Rules with Management and the Board.* Management and the board of directors should have a general understanding of the obligations the rules place on lawyers and how those rules fit into their company's overall compliance structure.
- *Decide whether to maintain a QLCC.* A QLCC takes the burden off the CLO to investigate and respond to reports of potential material violations and relieves the reporting attorney of his or her obligation to assess the adequacy of the response. Nonetheless, a QLCC places an additional burden on the directors designated to serve on the committee. Many companies will be reluctant to further burden their directors further, and directors may not want to assume the responsibilities associated with serving on such a committee. In addition, permitting attorneys to report directly to a QLCC may prevent the CLO from "filtering out" frivolous or unfounded reports that need not be addressed at the board level.
- *Identify the attorneys who may be covered by the rules.* Companies should identify the in-house

attorneys who may be viewed as "appearing and practicing" before the SEC, and should be aware that this list may change over time. For example, environmental attorneys may become involved in preparing SEC disclosure material when an environmental problem develops, and thus may be viewed as appearing before the SEC in connection with that material. Companies should also coordinate with their outside counsel as to the procedures to be followed if a reporting obligation is triggered by an outside attorney becoming aware of what could amount to a material violation.

- *Develop written policies and appropriate training programs.* Companies should develop and maintain a written policy and appropriate training programs for in-house attorneys who may be covered by the SEC rules to explain key terms, define attorneys' roles and duties, and help them understand and comply with the rules, and should review these policies periodically to confirm that they are up to date and appropriately tailored to the company. Any such attorney conduct policy should address how the rules interact with the company's broader code of conduct and confidentiality policies and should inform the CEO, CLO and board of directors of their obligations under the rules as well. New in-house attorneys should be alerted to their reporting obligations under the rules and trained when they begin employment.

- *Adopt written procedures for the CLO and board of directors.* Companies that have not already done so may want to develop written procedures for the CLO, board of directors and, where relevant, the QLCC, to follow upon receiving a report of a material violation. These procedures might address, for example, the circumstances under which the CLO or the board would conduct an internal investigation and the circumstances under which the CLO or the board might consider hiring an outside attorney to review the report. As noted above, a QLCC must have written procedures for the confidential receipt, retention and consideration of reports under the rules. Guidelines for the reporting of evidence by subordinate attorneys to supervisory attorneys and policies relating the additional oversight and reporting obligations of supervisory attorneys should also be included.

[4] The ABA Model Rules of Professional Conduct

The ABA's Model Rules of Professional Conduct set forth recommendations as to the conduct and responsibilities of lawyers. The rules provide guidance relating to the scope of the attorney-client relationship, the appropriate method in which to respond to evidence of a violation of law and the manner in which attorneys should report such violations. The rules implicate corporate governance as they dictate, to some extent, what attorneys may and may not do when they become aware of legal and regulatory violations that occur within their corporate clients. Though the rules are not binding, state bar associations look to the model rules in establishing their own rules of professional conduct. Model Rules 1.2, 1.6 and 1.13 speak to the attorney's duties and responsibilities in the context of corporate representation.ⁿ⁷¹

Model Rule 1.13 provides, "[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."ⁿ⁷² The attorney is obligated to the company itself, not its individual directors, officers or employees. If an officer, employee or other person associated with the company "is engaged in action, intends to act or refuses to act" so as to violate the law or a legal obligation to the organization, the lawyer must "proceed as is reasonably necessary in the best interest of the organization," if (1) the lawyer "knows" of the misconduct, (2) the matter "relate[s] to the representation [of the company]" and (3) the misconduct is "likely to result in substantial injury" to the company.ⁿ⁷³ Further, Model Rule 1.13(b) provides that "[u]nless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including ... the highest authority that can act on behalf of the organization" ⁿ⁷⁴ If this up the ladder reporting does not elicit an appropriate response, the lawyer may proceed to reveal information reasonably believed to be necessary to prevent substantial injury to the company, regardless of the duties of confidentiality imposed by Model Rule 1.6 (described below). Specifically, if (i) the company's highest authority insists upon the action or refuses to address it in a timely and appropriate manner, (ii) the action is "clearly a violation of law" and (iii) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the

organization," the lawyer may reveal information relating to the representation to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.ⁿ⁷⁵

Model Rule 1.2 complements Model Rule 1.13 by prohibiting a lawyer from "counsel[ing] a client to engage, or assist[ing] a client, in conduct that the lawyer knows is criminal or fraudulent"n76 This prohibition, much like the requirements of Model Rule 1.13, is limited to situations in which the lawyer "knows" the conduct is criminal or fraudulent.n77

Model Rule 1.6 sets forth the attorney's obligation to preserve attorney-client confidentiality and speaks directly to the situation in which the attorney may disclose client confidences. According to Model Rule 1.6(a), "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, [or] the disclosure is impliedly authorized in order to carry out the representation"n78 Model Rule 1.6(b) contains several exceptions to the duty of confidentiality, as it permits, *but does not require*, the lawyer to depart from this duty to the extent the lawyer reasonably believes necessary:

- "to prevent reasonably certain death or bodily harm";
- "to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services";
- "to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services";
- to secure legal advice about the lawyer's compliance with the Model Rules;
- to establish a claim or defense for himself or herself in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based on conduct in which the client was involved, or to respond to allegations in a proceeding concerning the lawyer's representation of the client; or
- to comply with a court order.n79

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersScope of AuthorityGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewLegal EthicsProfessional ConductGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingSarbanes Oxley ActSecurities LawU.S. Securities & Exchange CommissionAdministrative ProceedingsGeneral Overview

FOOTNOTES:

(n1)Footnote 1. Report of the American Bar Association Task Force on Corporate Responsibility 21 (Mar. 31, 2003), available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, 59 *Bus. Law.* 145 (2003).

(n2)Footnote 2. Remarks of William T. Allen, *Corporate Governance Post-Enron*, Bar Association of the City of New York 17 (Apr. 1, 2002).

(n3)Footnote 3. Report of the American Bar Association Task Force on Corporate Responsibility 23-24 (Mar. 31, 2003), available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, 59 *Bus. Law.* 145 (2003).

(n4)Footnote 4. See Robert E. Bostrom, *Corporate Governance, Risk Management and Compliance After Sarbanes-Oxley: Some Thoughts On Best Practices and the Role of General Counsel*, The Metropolitan Corporate Counsel, Oct. 2002, at 1.

(n5)Footnote 5. The ABA Task Force on Corporate Responsibility notes that good corporate governance involves routine periodic meetings between the general counsel and a committee of independent directors (such as the audit committee or nominating/corporate governance committee). According to James H. Cheek III, who chaired the Task Force, "[b]y establishing such a routine channel of direct communication, contact between the general counsel and outside directors becomes more innocuous and less revolutionary, and most likely encourages other senior executives to themselves report potential violations of law or breaches of fiduciary duty to independent directors or to respect to a greater extent the advice of the general counsel." See James H. Cheek III and Derek S. Hughey, *Emerging Responsibilities and Liabilities of the Corporate Lawyer*, 1343 *PLI/Corp* 1141, 1160 (2002).

(n6)Footnote 6. The ABA Task Force pointed out that in many situations, various personnel will be perceived as retaining outside counsel. This may discourage outside counsel from fulfilling its professional obligations out of a concern for not being retained in the future. As such, the ABA Task Force on Corporate Responsibility recommended that the general counsel establish, at the beginning of any retention by the corporation of outside counsel, a commitment by outside counsel to communicate directly with the general counsel upon learning of possible material violations of law or breaches of fiduciary duty by officers, employees or agents of the corporation. See James H. Cheek III and Derek S. Hughey, *Emerging Responsibilities and Liabilities of the Corporate Lawyer*, 1343 *PLI/Corp* 1141, 1161 (2002).

(n7)Footnote 7. See James H. Cheek III and Derek S. Hughey, *Emerging Responsibilities and Liabilities of the Corporate Lawyer*, 1343 *PLI/Corp* 1141, 1161 (2002).

(n8)Footnote 8. As discussed in further detail in § 14.07[4] below, some states require a lawyer to disclose confidential client information in certain situations.

(n9)Footnote 9. *In the Matter of William R. Carter, Charles J. Johnson Jr.*, 22 S.E.C. Docket No. 292, 30 (1981).

(n10)Footnote 10. See James H. Cheek III, Derek S. Hughey, *Emerging Responsibilities and Liabilities of the Corporate Lawyer*, 1343 *PLI/Corp* 1141, 1173 (2002).

(n11)Footnote 11. Sarbanes-Oxley Act § 307, 15 *U.S.C.* § 7245 (2009).

(n12)Footnote 12. Congress gave no indication that Section 307 was intended to generally preempt state law. The SEC, however, explained that while the SEC attorney conduct rules do not preempt ethical rules in states that establish more rigorous obligations, the rules do prevail over any conflicting or inconsistent laws of a state in which an attorney is admitted or practices. It is unclear, however, whether the SEC has the authority to preempt state laws and ethical rules.

(n13)Footnote 13. See SEC Release No. 33-8185 (Jan. 29, 2003). Sarbanes-Oxley § 307 and the related implementing rules, 17 *CFR* §§ 205.1-205.7, are reproduced in Appendix G to this treatise.

(n14)Footnote 14. See SEC Release No. 33-8185 (Jan. 29, 2003).

(n15)Footnote 15. "Attorney" is defined as "any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law." 17 *CFR* § 205.2(c) (2009).

(n16)Footnote 16. *See 17 CFR § 205.2(a) (2009)*. The meaning of the term "appearing and practicing" before the SEC is discussed in *Section14.07[3][b] below*.

(n17)Footnote 17. "In the representation of an issuer" means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer. *See 17 CFR § 205.2(g) (2009)*.

(n18)Footnote 18. "Evidence of a material violation" means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur. *See 17 CFR § 205.2(e) (2009)*.

(n19)Footnote 19. "Breach of fiduciary duty" refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions. *See 17 CFR § 205.2(d) (2009)*.

(n20)Footnote 20. This rule draws upon the ethics rule now in effect in most states.

(n21)Footnote 21. *See 17 CFR § 205.2(a) (2009)*.

(n22)Footnote 22. *See 17 CFR § 205.3(b)(5) (2009)*.

(n23)Footnote 23. *See § 14.07[3][c] below*.

(n24)Footnote 24. *See 17 CFR § 205.2(a)(2)(ii) (2009)*.

(n25)Footnote 25. *See 17 CFR § 205.2(j) (2009)*.

(n26)Footnote 26. *See 17 CFR § 205.6(d) (2009)*.

(n27)Footnote 27. *See 17 CFR § 205.3(b)(1) (2009)*.

(n28)Footnote 28. *See 17 CFR § 205.3(b)(1) (2009)*.

(n29)Footnote 29. *See 17 CFR § 205.3(b)(4) (2009)*.

(n30)Footnote 30. *See 17 CFR § 205.2(i) (2009)*.

(n31)Footnote 31. *See 17 CFR § 205.2(e) (2009)*.

(n32)Footnote 32. *See 17 CFR § 205.3(b)(6)(i) (2009)*.

(n33)Footnote 33. *See 17 CFR § 205.3(b)(6)(ii) (2009)*.

(n34)Footnote 34. *See 17 CFR § 205.3(b)(7) (2009)*.

(n35)Footnote 35. *See 17 CFR § 205.3(b)(2) (2009)*.

(n36)Footnote 36. *See 17 CFR § 205.3(b)(2) (2009)*.

(n37)Footnote 37. *17 CFR § 205.3(b)(2) (2009)*.

(n38)Footnote 38. *See 17 CFR § 205.3(b)(2) (2009)*.

(n39)Footnote 39. *See 17 CFR § 205.3(a)(3) (2009)*.

(n40)Footnote 40. *See 17 CFR § 205.2(b) (2009)*.

(n41)Footnote 41. See SEC Release No. 33-8185 (Jan. 29, 2003).

(n42)Footnote 42. See 17 CFR § 205.3(b)(9) (2009).

(n43)Footnote 43. See 17 CFR § 205.3(c) (2009).

(n44)Footnote 44. See 17 CFR § 205.3(c)(1) (2009).

(n45)Footnote 45. See 17 CFR § 205.3(c)(1) (2009).

(n46)Footnote 46. See 17 CFR § 205.3(c)(2) (2009).

(n47)Footnote 47. See 17 CFR § 205.3(c)(2) (2009).

(n48)Footnote 48. The SEC has "encourage[d] the use of a QLCC as a practice of good corporate governance." See Kenneth R. McVay, Scott S. Strobridge and Amada W. Reed, *Sarbanes-Oxley and Venture Capital-Backed Companies*, 5374 PLI/Corp 793, 798 (2004) (citing Patrick J. Schultheis, *Section 307 of the Sarbanes-Oxley Act and Related SEC Rules* (June 2003)). Nevertheless, the establishment of a QLCC is not required, and not many companies have established such committees.

(n49)Footnote 49. As defined in the Investment Company Act of 1940 § 2(a)(19).

(n50)Footnote 50. See 17 CFR § 205.2(k)(1) and (2) (2009).

(n51)Footnote 51. See 17 CFR § 205.2(k)(3)(i) (2009).

(n52)Footnote 52. See 17 CFR § 205.2(k)(3)(ii) (2009).

(n53)Footnote 53. See 17 CFR § 205.2(k)(3)(iii) (2009).

(n54)Footnote 54. See 17 CFR § 205.2(k)(4) (2009).

(n55)Footnote 55. See SEC Release No. 33-8185 (Jan. 29, 2003). Since the adoption of the rules, the existence of QLCCs has increased. According to The Corporate Counsel, as of May 2003, eleven companies disclosed in their shareholder proxy statements that they have established QLCCs. See The Corporate Counsel, *Qualified Legal Compliance Committees*, at http://www.thecorporatecounsel.net/member/FAQ/Disclosure/Legal_Compliance.htm. And according to a 2005 study, between October 2002 and September 30, 2005, only 456 issuers formed QLCCs. Robert Eli Rosen, *Resistance to Reforming Corporate Governance: The Diffusion of QLCC's*, 74 *Fordham L. Rev.* 1251, 1252 (Dec. 2005).

(n56)Footnote 56. See 17 CFR § 205.3(d)(1) (2009).

(n57)Footnote 57. See 17 CFR § 205.3(d)(2) (2009).

(n58)Footnote 58. See 17 CFR § 205.1 (2009).

(n59)Footnote 59. ABA Model Rule 1.13(c) permits a lawyer to reveal confidential information relating to the representation of an company to prevent substantial injury to the company if the lawyer has already referred the matter to higher authority within the organization. Also, ABA Model Rule 1.6(b) permits a lawyer to reveal client confidences to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services. See § 14.07[4] below for a discussion of the ABA Model Rules of Professional Conduct.

(n60)Footnote 60. See 17 CFR § 205.4(a) (2009).

(n61)Footnote 61. *See 17 CFR § 205.5(b) (2009).*

(n62)Footnote 62. *See 17 CFR § 205.4(b) (2009).*

(n63)Footnote 63. *See 17 CFR § 205.4(c) (2009).*

(n64)Footnote 64. *See 17 CFR § 205.5(b) (2009).*

(n65)Footnote 65. *See 17 CFR § 205.5(c) (2009).*

(n66)Footnote 66. *See 17 CFR § 205.6(a) (2009).*

(n67)Footnote 67. *See 17 CFR § 205.6(b) (2009).* In September 2004, the SEC entered a cease and desist order against John E. Isselmann, Jr., former general counsel of Electro Scientific Industries, Inc., in an enforcement action that, while technically not brought under the SEC attorney conduct rules (Isselmann's conduct occurred prior to the adoption of the rules), demonstrated the SEC's willingness to take action against attorneys for not appropriately responding to legal or regulatory violations. Here, the company's CFO represented to the audit committee that the elimination of a severance benefit for its Asian offices was approved by legal counsel. Isselmann ultimately learned of this representation as well as the subsequent opinion of the company's Japanese counsel that the benefits could not, in fact, be legally eliminated. Isselmann, however, took no action to correct the beliefs of the audit committee or the outside auditors. The SEC's complaint charged that Isselmann violated 1934 Act Rule 13b2-2 (regarding making false or materially misleading statements to accountants) and demonstrates the SEC's willingness to carefully review the actions taken (or not taken) of counsel in the face of violations of securities laws. More recently, on January 13, 2005, the SEC charged Google, Inc. for not adequately exempting from the registration provisions of Section 5 of the Securities Act the issuance of stock options to its employees. The SEC also charged Google's general counsel, David C. Drummond, for causing the violation. Google and Drummond ultimately agreed to cease and desist from the violations. The cease and desist order named no other Google officer other than Drummond. Though the Google action was not made under Part 205, it again evidences the SEC's strict stance with respect to attorneys. *See SEC Release 33-88523 (Jan. 13, 2005).*

(n68)Footnote 68. *See 17 CFR § 205.6(c) (2009).* As discussed *above*, some state bar associations have argued that the SEC does not have the authority to preempt state and local ethics standards in this way.

(n69)Footnote 69. *See 17 CFR § 205.7 (2009).*

(n70)Footnote 70. *See 17 CFR § 205.7 (2009).*

(n71)Footnote 71. In March 2002, Robert Hirshon, then the President of the ABA, appointed the ABA Task Force on Corporate Responsibility, charged with examining "systemic issues relating to corporate responsibility [and] ... examin[ing] the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants." The Task Force included several general counsels, corporate and securities lawyers, a business court judge and a former SEC commissioner. One of its tentative missions was to adopt proposals to permit lawyers to disclose client fraud. The Task Force published recommendations relating to the role of lawyers in March 2003. Alfred P. Carlton, Jr., the President of the ABA who succeeded Mr. Hirshon, presented the report as "the latest word in corporate governance reform and the role and ethical responsibilities of corporate counsel in this post-Enron age." The Task Force proposed amendments to the Model Rules in order to address more specifically the lawyer's duty and ability to report violations that could result in financial injury to the corporation and others. First, it proposed to amend Model Rule 1.13 by imposing a more explicit duty on corporate lawyers to communicate with higher corporate authority where other efforts fail to prevent or rectify misconduct. The Task Force also proposed two additional exceptions to the duty of confidentiality imposed by Rule 1.6. Mr. Olson was a member of the ABA Task Force. *See James H. Cheek III, Derek S. Hughey, Emerging Responsibilities and Liabilities of the Corporate Lawyer*, 1343 *PLI/Corp* 1141, 1156 (2002). The amendments were substantially adopted in August 2003.

(n72)Footnote 72. Model Rules of Prof'l Conduct R. 1.13(a) (2003).

(n73)Footnote 73. Model Rules of Prof'l Conduct R. 1.13(b) (2003).

(n74)Footnote 74. *See* Model Rules of Prof'l Conduct R. 1.13(b) (2003).

(n75)Footnote 75. *See* Model Rules of Prof'l Conduct R. 1.13(c) (2003). The duty to report information that would otherwise be protected by the duty of confidentiality marks a shift from the ABA's previous Rule 1.13. The old Model Rule 1.13 did not permit lawyers to report wrongdoing outside the company.

(n76)Footnote 76. Model Rules of Prof'l Conduct R. 1.2(d) (2002).

(n77)Footnote 77. *See* Model Rules of Prof'l Conduct R. 1.2 (2002).

(n78)Footnote 78. Model Rules of Prof'l Conduct R. 1.6(a) (2003).

(n79)Footnote 79. Model Rules of Prof'l Conduct R. 1.6(b) (2003). The amendment to Rule 1.6, which permitted lawyers to reveal information that otherwise would be protected by attorney-client confidentiality, passed the ABA's policymaking House of Delegates by a vote of 218 to 201. Model Rule 1.6, as amended, recognizes the exceptions currently also found in 42 states which either permit or require a lawyer to disclose confidential client information to prevent the client from perpetrating a criminal fraud. Eighteen states permit or require such disclosure to prevent or rectify substantial financial loss resulting from such crime or fraud in which the client used the lawyer's services.



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Corporate Governance: Law and Practice

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CHAPTER 14 ROLES AND RESPONSIBILITIES OF NON-BOARD PARTICIPANTS IN CORPORATE GOVERNANCE

2-14 Corporate Governance: Law and Practice § 14.08

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§ 14.08 The Independent Public Accountants

[1] Overview of Auditor Independence

Though ultimately the responsibility of the company, the production of financial statements that accurately present the issuer's financial condition requires an outside auditor that is dedicated to this goal.ⁿ¹ Regardless of how proactive and attentive they are, no auditor or audit committee can detect every fraudulent act or overly aggressive accounting practice. It is not their job to do so.

Auditors who do not maintain independence from their audit clients, however, are less likely to conduct the audit effectively, and may ignore problems that arise along the way.ⁿ² When the outside auditor's independence is compromised, effective corporate governance may also be compromised, as an interested auditor will have less incentive to critique a flawed component of the system. As such, breakdowns in the independence of outside auditors have been blamed by some as factors in the accounting scandals that led to the adoption of the Sarbanes-Oxley Act. Title II of the Sarbanes-Oxley Act and the SEC rules adopted thereunder were intended to increase the reliability of financial statements by enhancing auditor independence and by creating a new body to monitor the auditing profession, the Public Company Accounting Oversight Board ("PCAOB"). The SEC's independence rules focus on the following key areas of auditor independence:

- prohibiting the auditor from acting as management or as an employee of the audit client;
- prohibiting an auditor from auditing his or her own work;
- prohibiting an auditor from serving as an advocate for his or her client; and
- prohibiting an auditor from having mutual or conflicting interests with his or her client.

Title II of the Sarbanes-Oxley Act further developed and expanded upon the SEC's pre-existing independence standards by doing the following:ⁿ³

- enhancing conflict of interest standards;
- prohibiting outside auditors from providing specified non-audit services;ⁿ⁴
- requiring partner rotation and second partner review; and
- clarifying and enhancing the relationship between the outside auditor and the audit committee.

[2] Provision of Audit and Non-Audit Services

[a] Non-Audit Services

While in the past companies had turned to their outside auditor to perform a variety of non-audit services, the Sarbanes-Oxley Act, and the SEC's rules adopted thereunder, provide for enhanced auditor independence by restricting the extent to which auditors are permitted to provide non-audit services to their audit clients. Section 10A(g) of the 1934 Act (adopted pursuant to Section 201(a) of the Sarbanes-Oxley Act) provides that it is unlawful for a registered public accounting firm (and any associated person of that firm) that performs an audit for an issuer to provide certain non-audit services for that issuer contemporaneously with the audit.ⁿ⁵ The SEC interpreted and expanded upon Section 10A(g) in adopting Rule 2-01(c)(4) of Regulation S-X. Rule 2-01(c)(4) provides that an outside auditor is not independentⁿ⁶ if it provides any one of the following ten non-audit services to an audit client:

1. *Bookkeeping or other services related to the accounting records or financial statements of the audit client.* ⁿ⁷ Bookkeeping or other services focuses on the provision of services involving: (1) maintaining or preparing the audit client's accounting records; (2) preparing financial statements filed with the SEC or the information that forms the basis of such financial statements; and (3) preparing or originating source data underlying the audit client's financial statements.ⁿ⁸
2. *Financial information systems design and implementation.* ⁿ⁹ These services include: (1) directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network; or (2) designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information significant to the audit client's financial statements or other financial information systems taken as a whole. The prohibition on financial information systems design and implementation services does not preclude outside auditors from evaluating the internal controls of a system as it is being designed, implemented or operated either as part of an audit or attest service and making recommendations to management or making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.ⁿ¹⁰
3. *Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.* ⁿ¹¹ The SEC has not prohibited the provision of these services for non-financial reporting such as transfer pricing studies, cost segregation studies and other tax-only valuations purposes. The rules also do not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise the client uses in determining the required amounts recorded in the client financial statements. In those instances the outside auditor will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit.ⁿ¹²
4. *Actuarial services.* ⁿ¹³ Actuarial services include any actuarially-oriented advisory service involving

the determination of amounts recorded in the financial statements and related accounts for the audit client. The prohibition does not include assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount. The rules also do not prohibit the outside auditor from providing services for non-financial reporting purposes, such as transfer pricing studies, cost segregation studies and other tax-only valuations and do not prohibit the auditor from advising the audit client on the appropriate actuarial methods and assumptions that will be used in the actuarial valuations.ⁿ¹⁴

5. *Internal audit outsourcing services.* ⁿ¹⁵ Internal audit outsourcing services include any services that have been outsourced and that relate to the audit client's internal accounting controls, financial systems, or financial statements. The prohibition on "outsourcing" does not preclude engaging the outside auditor to perform nonrecurring evaluations of discrete items or other programs that are not, in substance, the outsourcing of the internal audit function. For example, the company may engage the outside auditor (subject to the audit committee pre-approval requirements, as discussed in § 14.08[2][b] below) to conduct "agreed-upon procedures" related to the company's internal control over financial reporting, since management takes responsibility for the scope and assertions in those engagements. The prohibition also does not preclude outside auditors from performing operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.ⁿ¹⁶

6. *Management functions.* ⁿ¹⁷ The prohibition on management functions refers to acting (temporarily or permanently) as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. The SEC believes that "services in connection with the assessment of internal accounting and risk management controls, as well as providing recommendations for improvements, do not impair an outside auditor's independence."ⁿ¹⁸

7. *Human resources.* ⁿ¹⁹ The prohibition on the provision of human resources services covers: (1) "searching for or seeking out prospective candidates for managerial, executive, or director positions;" (2) "engaging in psychological testing, or other formal testing or evaluation programs;" (3) "undertaking reference checks of prospective candidates for an executive or director position;" (4) "acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment;" or (5) "recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative or control positions)."

8. *Broker or dealer, investment adviser, or investment banking services.* ⁿ²⁰ These services include (1) acting as a broker-dealer (registered or unregistered), promoter, or underwriter on behalf of an audit client, (2) making investment decisions on behalf of an audit client or otherwise having discretionary authority over an audit client's investments, (3) executing a transaction to buy or sell an audit client's investment, and (4) having custody of assets of the audit client, such as taking temporary possession of securities purchased by an audit client.

9. *Legal services.* ⁿ²¹ Legal services include providing a service to an audit client that could be properly provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.ⁿ²²

10. *Expert services unrelated to the audit.* ⁿ²³ Expert services unrelated to the audit include the provision of an expert opinion or other expert service for the purpose of advocating the audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. An outside auditor may provide factual accounts, including testimony regarding work performed or an explanation of the

positions taken or conclusions reached during the performance of any permitted service provided by the outside auditor for the audit client. The rules also do not preclude an audit committee or, at its direction, its attorney, from engaging the outside auditor to perform internal investigations or fact finding engagements, nor do they prohibit an auditor from assisting the audit committee in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety. For example, the company's audit committee may engage the auditor to conduct a thorough inspection and analysis of those accounts, the physical inventory at the subsidiary, and related matters, without impairing the auditor's independence.

According to Section 10A(g) of the 1934 Act, any non-audit service (including tax services) that is not one of the prohibited non-audit services can be provided by the auditor without impairing its independence, but only to the extent such services has been pre-approved by the issuer's audit committee.ⁿ²⁴ Preapproval of audit and permissible non-audit services is discussed further below. ⁿ²⁵

Questions whether tax services constitute a prohibited non-audit service have engendered significant debate. The SEC in its audit services adopting release specifically stated that an accounting firm can provide tax services to its audit clients without impairing its independence. The SEC's position on tax services is not unlimited, however. An outside auditor would impair its independence by representing an audit client before a tax court. The Conference Board Commission on Public Trust and Private Enterprise noted that tax strategies involving tax shelters, offshore partnerships and other novel and debatable structures should not be obtained from the independent auditors, as debatable strategies, if implemented, could then be blessed by the auditor as part of the audits. In the view of the Conference Board, the impartiality required to perform an effective audit is compromised by auditor's financial incentive to approve of the structure or technique it suggested.ⁿ²⁶ On March 25, 2003, PCAOB member Daniel Goelzer urged corporations to stay away from questionable tax shelter transactions that are marketed by their outside auditors. He said that while the PCAOB could opt to ban all tax activities by auditors, the simpler solution is for corporate boards to refuse to approve the corporation's use of any tax shelters from the accounting firm that audits their financial statements. "Auditors should not be in the position of marketing shelters to their audit clients. Novel products and tax services put the auditor on a slippery slope. First, the auditor becomes an advocate for the client if the IRS questions the tax treatment, and second, the auditor is in the position of auditing its own work."ⁿ²⁷

On July 26, 2005, the PCAOB formally joined the discussion of tax services, by adopting its own rules specifically relating to independence and tax services.ⁿ²⁸ Under the PCAOB's rules, an outside auditor would not be independent of an audit client if, among other things, (1) it entered into a contingent fee arrangement, (2) it provided services relating to marketing, planning or opining in favor of a tax treatment of a transaction that is a confidential transaction, (3) it provided services relating to marketing, planning or opining in favor of a tax treatment on a transaction that is based on an aggressive interpretation of a tax law or (4) it provided tax services to certain members of management who serve in financial reporting oversight roles to audit clients or to immediate family members of such persons. The PCAOB's rules also expand the responsibilities for which the outside auditor has to seek the pre-approval of the audit committee.ⁿ²⁹

[b] Audit Committee Approval of Audit Services and Permissible Non-Audit Services

Section 202 of the Sarbanes-Oxley Act and the related SEC auditor independence rules also obligate companies to strengthen corporate governance by requiring the audit engagement to be approved by the audit committee.ⁿ³⁰ The rules provide that an outside auditor is not independent unless either the engagement is approved by the company's audit committee before the commencement of the engagement or the engagement to render a service being provided is entered into pursuant to an acceptable pre-approval policy established by the company's audit committee.ⁿ³¹ Any pre-approval policy employed by an issuer's audit committee for either audit or non-audit services must be detailed as to the particular service and may not delegate audit committee responsibilities required under the 1934 Act to management.ⁿ³² Even if they are approved by the audit committee, non-audit services can only be provided if they do not impair the auditor's independence.ⁿ³³ The audit committee may delegate the authority to grant pre-approvals to one

or more of its members.ⁿ³⁴ In conjunction with the release of Auditing Standard No. 5, the PCAOB issued Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control over Financial Reporting, requiring accounting firms seeking pre-approval to first (1) describe the scope of the proposed non-audit service to the committee in writing, (2) discuss with the committee the potential effects of the service on the independence of the firm, and (3) document the substance of those discussions.ⁿ³⁵

[3] Communication with Audit Committees

The Sarbanes-Oxley Act greatly expanded the role of the audit committee.ⁿ³⁶ Section 204, which added a new Section 10A(k) to the 1934 Act, requires auditors to provide information to the audit committee, over and above that required by Generally Accepted Accounting Standards (GAAS) and the accounting literature.ⁿ³⁷ Pursuant to Section 204 of the Sarbanes-Oxley Act, accountants that audit issuer financial statements must report the following information to the audit committee of that issuer in a timely manner:

- all critical accounting polices and practices to be used;
- all alternative treatments of financial information within GAAP that have been discussed with management, the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the accounting firm; and
- other material written communications between the accounting firm and management, such as any management letter or schedule of unadjusted difference.ⁿ³⁸

The SEC adopted rules to clarify the scope and meaning of Section 204.ⁿ³⁹ Rule 2-07 of Regulation S-X provides that disclosure of "alternative treatments" of financial information" is only required to the extent they are for "policies and practices related to material terms" that have been discussed with management.ⁿ⁴⁰ Rule 2-07 also provides that the required information must be provided to the audit committee prior to filing the related audit report with the SEC.ⁿ⁴¹ Pursuant to PCAOB's Auditing Standard No.5 and related SEC and PCAOB guidance, outside auditors are also required to communicate with the audit committee as described in *§14.08[5] below*.

[4] The Public Company Accounting Oversight Board

[a] What is the Public Company Accounting Oversight Board?

The goal of the Public Company Accounting Oversight Board (PCAOB), established by Section 101 of the Sarbanes-Oxley Act, is to protect the public interest through regulation of the process by which accounting firms prepare independent audit reports.ⁿ⁴² It derives its funding primarily from fee assessments on issuers and registration fees paid by accounting firms that audit public companies and, pursuant to the Sarbanes-Oxley Act, will exist until it is specifically dissolved by an act of Congress. It consists of five members, all of whom, including its chair, are appointed by the SEC, and two of whom must be current or former certified public accountants.

[b] Duties and Authority of the Public Company Accounting Oversight Board

Because outside auditors review both the company's financial statements and the material adequacy of internal control over financial reporting, the outside auditor has an opportunity to review and provide input on significant parts of the company's overall governance structure. The PCAOB establishes standards for auditing, quality control, ethics and independence. Its major functions are to conduct inspections and investigations of public accounting firms and to impose sanctions when an investigation leads it to believe such sanctions are necessary. The PCAOB is also responsible for (1) registering public accounting firms, (2) establishing standards relating to the preparation of audit reports, and (3) enforcing compliance with the Sarbanes-Oxley Act, the rules established by the PCAOB, and the federal securities laws to the extent they apply to public accountants. All accounting firms that perform audits or participate in the production

of audit reports with respect to an issuer of publicly traded securities (including foreign issuers whose securities are traded in the United States) must register with the PCAOB, and each registered public accounting firm must, at least annually, submit a report to the PCAOB.ⁿ⁴³

The PCAOB is charged with issuing auditing standards requiring each registered public accounting firm to:

- maintain audit work papers for at least seven years (in sufficient detail to support the conclusions reached in the audit);
- provide a second partner review and approval of audit reports; and
- describe in each audit report the scope of the auditor's testing of the internal control structure of the issuer, as required by Section 404(b) of the Sarbanes-Oxley Act.ⁿ⁴⁴

The PCAOB is also required to issue quality control standards relating to (1) the monitoring of professional ethics and independence from audit clients, (2) internal consultation on accounting and auditing questions, (3) supervision of audit work, (4) hiring and development of personnel, (5) the acceptance and continuation of engagements (6) internal inspection, and (7) such other requirements as the PCAOB may prescribe.ⁿ⁴⁵ In order to enforce these quality control standards the PCAOB conducts inspections of auditors on an ongoing basis to assess their degree of compliance.ⁿ⁴⁶ Accounting firms that regularly provide audit reports for more than one hundred issuers are inspected annually and accounting firms that regularly provide audit reports to one hundred or fewer issuers are inspected every three years.ⁿ⁴⁷

Since its creation, the PCAOB has issued standards and rules relating to the outside auditor's audit of internal control over financial reporting, audit documentation, reporting on whether a previously reported material weakness continues to exist, audit committee approval of tax services and contingent fees, and many others issues.ⁿ⁴⁸

[c] Penalties

Section 105 of the Sarbanes-Oxley Act endows the PCAOB with the ability to conduct investigations of any public accounting firm (including any associated person of that firm) in relation to a potential violation by that firm (or associated person) of the Sarbanes-Oxley Act, the rules of the PCAOB, the securities laws relating to the preparation and issuance of audit reports and SEC rules adopted under the Sarbanes-Oxley Act.ⁿ⁴⁹ The PCAOB's rules may also require accounting firms to testify and produce audit papers and other information to the extent necessary to conduct an investigation. Additionally, the PCAOB is given the power to issue suspensions, revoke registrations and issue other sanctions to public accounting firms or associated persons that refuse to testify, produce documents or otherwise cooperate with the PCAOB in this regard.

If the PCAOB finds that a registered public accounting firm violated the Sarbanes-Oxley Act, the SEC's rules adopted pursuant to the Sarbanes-Oxley Act, the PCAOB's rules or any provision of the securities laws relating to the preparation and issuance of audit reports, the PCAOB may impose sanctions to the extent it deems appropriate.ⁿ⁵⁰ PCAOB sanctions can include temporary or permanent (1) revocation of registration, (2) suspension, and (3) limitation on activities and operations.ⁿ⁵¹ The PCAOB can also impose a civil penalty of up to \$100,000 for a natural person or \$2,000,000 for an entity, and in the case of intentional, knowing or reckless conduct, \$750,000 for a natural person and \$15,000,000 for an entity.ⁿ⁵²

[5] The Outside Auditor's Report on Internal Control Over Financial Reporting

The rules adopted by the SEC pursuant to Section 404(b) of the Sarbanes-Oxley Act require issuers to include in annual reports their outside auditor's attestation as to the effectiveness of the issuer's internal control over financial reporting.ⁿ⁵³ This attestation must be made in accordance with the standards for attestation engagements adopted by

the PCAOB.ⁿ⁵⁴ As directed by the Sarbanes-Oxley Act, in 2007 the PCAOB approved such a standard—the PCAOB's Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*. Auditing Standard No. 5 addresses the requirements under Section 404 of the Sarbanes-Oxley Act that an issuer's auditor attest to and report on management's required assessment of internal control over financial reporting. Auditing Standard No. 5 refers to the attestation engagement as an audit of internal control over financial reporting.ⁿ⁵⁵

Under the standard, auditors are required a report containing an opinion on internal control over financial reporting (the company's financial statements), both of which must be included in the issuer's annual report on Form 10-K. The auditor's report can either be a combined report (*i.e.* one report containing the opinion on internal control over financial reporting and an opinion on the issuer's financial statements) or the auditor can issue separate reports for each of the issuer's internal control over financial reporting and the issuer's financial statements. The auditor's opinion on internal control over financial report must opine as to whether the issuer maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the relevant control criteria.ⁿ⁵⁶ In performing the auditor's internal control over financial reporting audit, Auditing Standard No. 5 establishes thresholds the auditor must apply in determining whether significant deficiencies or material weaknesses exist in the issuer's internal control over financial reporting.ⁿ⁵⁷

Auditing Standard No. 5 was intended to align the costs and benefits of the internal control over financial reporting audit better than its predecessor, Auditing Standard No. 2, by focusing auditors on the matters most important to internal control, further encouraging the use of the work of others, eliminating unnecessary procedures, scaling the audit for smaller companies and simplifying auditing requirements. In announcing the new standard, the PCAOB described Auditing Standard No. 5 as "principles-based" and "designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatements of a company's financial statements."ⁿ⁵⁸ The PCAOB's goals included eliminating unnecessary procedures and tailoring the audit to individual issuers' facts and circumstances. To that end, Auditing Standard No. 5 emphasizes the use of scalable procedures, and the PCAOB followed Accounting Standard No. 5's release by issuing guidance for auditors of smaller public companies in January, 2009.ⁿ⁵⁹

Accounting Standard No. 5, as released:

- aligns key terms and concepts with terms used in SEC rules and guidance;ⁿ⁶⁰
- includes a discussion of fraud risk and anti-fraud controls at the beginning of the standard, to emphasize the importance of these matters in assessing risk;
- explains how different kinds of entity-level controls have different effects on the selection and testing of controls and how analysis at the entity level may reduce the need for testing of the underlying, process-level controls;
- focuses auditors on the objectives of a properly performed walkthrough rather than simply mandating performance of walkthroughs, which might lead to a checklist approach;
- emphasizes that auditors need not scope the audit to find deficiencies that, individually or when aggregated with other deficiencies, do not constitute material weaknesses;ⁿ⁶¹
- expressly permits auditors to use, in the internal control audit, testing and other internal control work of persons other than internal auditors; and
- allows auditors to tailor their top-down approach to the circumstances of individual companies by

removing the requirement to identify major classes of transactions and significant processes specifically before identifying relevant assertions.ⁿ⁶²

* * *

Auditing Standard No. 5 requires the outside auditor's report to include the following key components, among others:ⁿ⁶³

- a statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;
- an identification of management's report on internal control;
- a statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on the auditor's audit;
- a definition of internal control over financial reporting as stated in Auditing Standard No. 5;
- a statement that the audit was conducted in accordance with the standards of the PCAOB;
- a statement that the standards of the PCAOB require the auditor to plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;
- a statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;
- a statement that the auditor believes the audit provides a reasonable basis for the auditor's opinion;
- a paragraph stating that, because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate; and
- the auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting, as of the specified date, based on the control criteria.ⁿ⁶⁴

Auditing Standard No. 5 emphasizes the importance of the auditor's judgment and experience with prior audits of the issuer to planning and executing the audit, and calls on the auditor to utilize a top-down approach in planning an audit that reflects the risks presented by the particular issuer being audited, and is scaled accordingly.ⁿ⁶⁵ The standard stresses the importance of considering the likelihood of fraud in determining the entity-level and other controls to select for testing, guiding the auditor to contemplate controls over unusual transactions, period-end adjustments, related party transactions, and significant management estimates, as well as controls that could mitigate incentives and pressures that could cause management to falsify results.ⁿ⁶⁶

In addition to setting forth the substantive makeup of the outside auditor's internal control report and the procedures required for the auditor's audit of internal control over financial reporting, Auditing Standard No. 2 provides numerous instances in which the outside auditor is required to interface with various corporate constituencies throughout its

evaluation in order to arrive at the conclusions that will ultimately be included in the report. For example, Auditing Standard No. 5 notes that the auditor does not have the same level of familiarity of the company's controls that management has, and does not interact or observe these controls as frequently as management does, and thus acknowledges that the auditor cannot obtain sufficient evidence to support its internal control opinion without performing procedures such as "inquiry, observation and inspection of documents, or walkthroughs ..."n67 Auditing Standard No. 5 therefore allows the auditor to use the work of others in order to obtain evidence regarding the design and operating effectiveness of controls. The outside auditor may use the work performed by or receive direct assistance from the internal auditors, other company personnel and third parties working under the direction of management or the audit committee.n68

Auditing Standard No. 5 also requires the outside auditor to, as part of its audit, obtain a written representation from management (i) describing management's responsibilities and conclusions and whether certain changes in internal control over financial reporting have occurred, (ii) disclosing the effectiveness of internal control over financial reporting, and that management has disclosed to the outside auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation and (iii) disclosing whether any material fraud or other fraud involving an employee with a significant role in internal control over financial reporting has been identified.n69

If the auditor discovers any material weaknesses during the course of its audit, the auditor must communicate those material weaknesses to management and the audit committee.n70 The auditor must also consider whether during the course of its audit it has identified any deficiencies or combinations of deficiencies that constitute significant deficiencies and communicate these significant deficiencies to the audit committee as well.n71 If the auditor discovers deficiencies that do not amount to a significant deficiency or material weakness, it must communicate those deficiencies to management, and inform the audit committee when such communication has been made.n72 Finally, if the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the full board of directors.n73

If the outside auditor identifies significant deficiencies or material weaknesses during the course of its audit, management will need to take steps to remediate these issues, as set forth in Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist.n74 Auditing Standard No. 4 relates to the engagement of the outside auditor to report on the elimination of a material weakness. The standard provides for a voluntary, stand-alone engagement of the auditor to express an opinion solely on whether the company has eliminated a previously reported material weakness. The report provided by the auditor would be based on a written report by management that the identified material weakness has been eliminated. This report provided by management would include (1) a statement of management's responsibility for establishing and maintaining effective internal control over financial reporting; (2) a statement identifying the control criteria used (*e.g.* the COSO Framework); (3) an identification of the material weakness identified during the annual assessment; (4) an identification of the controls that address the material weakness; and (5) a statement that the material weakness no longer exists as of a specified date because the specified controls are effective in addressing the material weakness. The outside auditor's evaluation would be similar to the annual evaluation of internal control over financial reporting, but would focus only on the controls specifically identified by management in addressing the material weakness.n75

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesGeneral OverviewBusiness & Corporate LawCorporationsFinanceGeneral OverviewBusiness & Corporate LawCorporationsGoverning Documents & ProceduresGeneral OverviewSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Issuer Recordkeeping & ReportingGeneral OverviewSecurities LawAdditional

Offerings & the Securities Exchange Act of 1934 Issuer Recordkeeping & Reporting Sarbanes Oxley Act

FOOTNOTES:

(n1)Footnote 1. Accountants who audit financial statements are generally not permitted to act as advocates for their clients. *See generally* Regulation S-X Rule 2-01, *17 CFR § 210.2-01 (2009)*. Rather, the independent auditor's purpose is to increase investor confidence by auditing financial statements for reliability and accuracy. As articulated by Judge Friendly in the seminal case of *United States v. Simon*, the auditor's obligation to produce reliable and accurate financial statements requires more than simply confirming that the financial statements were prepared in accordance with GAAP. *See United States v. Simon*, *425 F.2d 796 (2d Cir. 1969)*. If compliance with GAAP results in financial statements that are materially misleading, accountants may still be held criminally liable. In March 2002, the General Accounting Office (GAO), in its Corporate Governance, Transparency and Accountability Forum reiterated this principal, stating that auditors should concern themselves with whether the financial statements "fairly present the financial condition" of the entity in all material respects-conformity with GAAP is not enough. General Accounting Office, Highlights of GAO's Corporate Governance, Transparency and Accountability Forum, GAO-02-494SP, 2 (Mar. 2002).

(n2)Footnote 2. According to former SEC chairman Roderick Hills (in testimony before the Senate Banking Committee), "[i]t is increasingly clear that the accounting profession is not able consistently to resist management pressures to permit incomplete or misleading financial statements, and the profession has serious problems in recruiting and keeping the highly qualified professionals that are needed." Roderick M. Hills, *Statement of the Honorable Roderick M. Hills Before the Committee on Financial Services, United States House of Representatives* (Mar. 13, 2002), at financialservices.house.gov/media/pdf/031302rh.pdf.

(n3)Footnote 3. Title II of the Sarbanes-Oxley Act added subsections (g) through (l) to Section 10A of the 1934 Act. In March 2003 the SEC first adopted rules related to Title II. Section 201 of the Sarbanes-Oxley Act added subsection (g) to 1934 Act § 10A, which specifies that certain non-audit services are prohibited. Section 201 also added subsection (h), which requires that both audit services and non-audit services not prohibited under the Sarbanes-Oxley Act and the SEC's rules be subject to pre-approval by the registrant's audit committee. Section 202 added subsection (i), which requires an audit committee to pre-approve permissible non-audit services and specifies certain exceptions to the pre-approval requirement. Section 203 added subsection (j), which establishes mandatory rotation of the lead partner and the concurring partner every five years. Section 204 added subsection (k) which requires the auditor to report certain information to the audit committee on a timely basis. Section 206 added subsection (l), regarding conflicts of interest.

(n4)Footnote 4. The provision of non-audit services is discussed in *Section 14.08[2][a] below*.

(n5)Footnote 5. *See* Section 10A(g) of the 1934 Act. As discussed further in *§ 14.08[2][b] below*, Regulation S-X Rule 2-01(c)(7) also requires the audit engagement to be approved by the audit committee before an accountant can render audit or non-audit services.

(n6)Footnote 6. 1934 Act Rule 10A-2 provides that it is unlawful for an auditor to not be independent.

(n7)Footnote 7. *See* Regulation S-X Rule 2-01(c)(4)(i), *17 CFR § 210.2-01(c)(4)(i) (2009)*.

(n8)Footnote 8. Before the adoption of the Sarbanes-Oxley Act, an auditor's independence was not considered to be impaired by providing bookkeeping services in limited circumstances, such as in an emergency or where the services were provided in a foreign jurisdiction and certain conditions were met. Regulation S-X Rule 2-01(c)(4)(i) eliminates these limited exceptions.

(n9)Footnote 9. *See* Regulation S-X Rule 2-01(c)(4)(ii), *17 CFR § 210.2-01(c)(4)(ii) (2009)*.

(n10)Footnote 10. *See* SEC Release No. 33-8183 (Jan. 28, 2003). The SEC has reiterated its position that while the auditor cannot audit its own work, it can discuss internal control and financial reporting issues with its client. *See* SEC

Division of Corporation Finance, Office of the Chief Accountant, *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (May 16, 2005).

(n11)Footnote 11. *See* Regulation S-X Rule 2-01(c)(4)(iii), 17 CFR § 210.2-01(c)(4)(iii) (2009).

(n12)Footnote 12. *See* SEC Release No. 33-8183 (Jan. 28, 2003). Before the adoption of the Sarbanes-Oxley Act, the auditor independence rules contained several exemptions to this prohibition. These exemptions have been eliminated.

(n13)Footnote 13. *See* Regulation S-X Rule 2-01(c)(4)(iv), 17 CFR § 210.2-01(c)(4)(iv) (2009).

(n14)Footnote 14. *See* SEC Release No. 33-8183 (Jan. 28, 2003) *amended by* SEC Release No. 33-8183A (Mar. 31, 2003).

(n15)Footnote 15. *See* Regulation S-X Rule 2-01(c)(4)(v), 17 CFR § 210.2-01(c)(4)(v) (2009).

(n16)Footnote 16. Prior to the adoption of the Sarbanes-Oxley Act, the SEC's auditor independence rules permitted companies to outsource part of their internal audit function to the outside auditor, subject to certain exceptions.

(n17)Footnote 17. *See* Regulation S-X Rule 2-01(c)(4)(vi), 17 CFR § 210.2-01(c)(4)(vi) (2009).

(n18)Footnote 18. *See* SEC Release No. 33-8183 (Jan. 28, 2003) *amended by* SEC Release No. 33-8183A (Mar. 31, 2003).

(n19)Footnote 19. *See* Regulation S-X Rule 2-01(c)(4)(vii), 17 CFR § 210.2-01(c)(4)(vii) (2009).

(n20)Footnote 20. *See* Regulation S-X Rule 2-01(c)(4)(viii), 17 CFR § 210.2-01(c)(4)(viii) (2009).

(n21)Footnote 21. *See* Regulation S-X Rule 2-01(c)(4)(ix), 17 CFR § 210.2-01(c)(4)(ix) (2009).

(n22)Footnote 22. The provision of tax services is discussed below.

(n23)Footnote 23. *See* Regulation S-X Rule 2-01(c)(4)(x), 17 CFR § 210.2-01(c)(4)(x) (2009). The provision of tax services is discussed *below*.

(n24)Footnote 24. *See* 1934 Act § 10A(g). Note that the Office of the Chief Accountant stated that there is a rebuttable presumption that the prohibited services will be subject to audit procedures. *See* Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions - Prohibited and Non-Audit Services, Question 4.

(n25)Footnote 25. *See* § 14.08[2][b] *below*.

(n26)Footnote 26. *See* The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 41 (2003), http://www.conference-board.org/pdf_free/SR-03-04.pdf.

(n27)Footnote 27. *Auditor Independence--Goelzer Urges Corporations To Say No To Tax Shelters Promoted By Their Auditors*, Securities Regulation & Law Report (BNA) Vol. 35, No. 13 (Mar. 31, 2003), at <http://pubs.bna.com/ip/BNA/SRLR.NSF/85256269004a991e8525611300214487/e5e3db5800772dd385256cf70082525f?OpenDocument>.

(n28)Footnote 28. *See* PCAOB Release No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services, And Contingent Fees* (July 26, 2005). The PCAOB's rules were effective when approved by the SEC on April 16, 2006.

(n29)Footnote 29. The SEC's pre-approval rules are discussed in §14.08[2][b] below.

(n30)Footnote 30. The roles and responsibilities of audit committees are discussed in Chapter 9 above.

(n31)Footnote 31. See Regulation S-X Rule 2-01(c)(7), 17 CFR § 210.2-01(c)(7) (2009).

(n32)Footnote 32. The SEC's Office of Chief Accountant has stated that the audit committee's pre-approval policies and procedures cannot provide for broad, categorical approvals; rather, they must be detailed as to the particular services to be provided. The determination of the appropriate level of detail will differ depending on the specific facts and circumstances. See Office of Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions - Audit Committee Pre-Approval, Questions 4-5.

(n33)Footnote 33. The provision of nonaudit services must also be disclosed to investors in periodic reports, pursuant to Section 10A(i)(2) of the 1934 Act, regardless of whether they are approved by the audit committee. Note that Section 10A(i)(2) only requires this disclosure in periodic reports required by Section 13(a) of the 1934 Act. In addition issuers must disclose in proxy statements each of the audit fees, audit related fees, tax fees and all other fees billed by their outside auditor. See Item 9 and SEC Schedule 14A.

(n34)Footnote 34. See 1934 Act § 10A(i)(3). The rules contain a limited *de minimis* exception solely related to the provision of services other than audit, review or attest services. See Regulation S-X Rule 2-01(c)(7)(i)(C), 17 CFR § 210.2-01(c)(7)(i)(C) (2009). The audit committee's responsibility with respect to the appointment, compensation, retention and oversight of the outside auditor are discussed in Chapter 9 above.

(n35)Footnote 35. PCAOB, Release 2007-005A (July 27, 2007).

(n36)Footnote 36. See discussion of the audit committee in Chapter 9 above.

(n37)Footnote 37. GAAS requires that the outside auditor ensure the audit committee is informed about matters such as: (1) auditor's responsibility under GAAS; (2) significant accounting policies; (3) methods used to account for significant unusual transactions; (4) effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (5) process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; (6) material audit adjustments proposed and immaterial adjustments not recorded by management; (7) auditor's judgments about the quality of the company's accounting principles; (8) auditor's responsibility for other information in documents containing audited financial statements; (9) auditor's views about significant matters that were the subject of consultation between management and other accountants; (10) major issues discussed with management prior to retention; (11) difficulties with management encountered in performing the audit; and (12) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements. See SEC Release No. 33-8183 (Jan. 28, 2003).

(n38)Footnote 38. The SEC indicated that the following are material communications: the management representation letter; reports on observations and recommendations on internal controls; the schedule of material adjustments and reclassifications and reclassifications proposed, and a listing of adjustments and reclassifications not recorded, if any; the engagement letter, if any; and the independence letter. See Release No. 33-8154 (Dec. 2, 2002).

(n39)Footnote 39. In its adopting release, the SEC quoted Warren Buffet, who described the interaction between the auditor and the audit committee as follows: "Their function ... is to hold the auditor's feet to the fire. And, I suggest ... the audit committee ask [questions] of the auditors [including]: if the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way differently than the manner selected by management? They should inquire as to both material and non-material differences. If the auditor would have done anything differently than management, then explanations should be made of management's argument and the auditor's response." SEC Release No. 33-8185 (Jan. 29, 2003).

(n40)Footnote 40. *See* Regulation S-X Rule 2-07(a)(2), *17 CFR § 210.2-07(a)(2) (2009)*.

(n41)Footnote 41. *See* Regulation S-X Rule 2-07(a), *17 CFR § 210.2-07(a) (2009)*. In August 2003 the Office of the Chief Accountant released a set of frequently asked questions clarifying the SEC's rules adopted pursuant to Section 204 of the Sarbanes-Oxley Act. These interpretations specify with greater clarity under what circumstances communication with the audit committee is required. *See* Office of the Chief Accountant, Application of the January 2003 Rules on Auditor Independence Frequently Asked Questions, Questions 25-29.

(n42)Footnote 42. Section 101 of the Sarbanes-Oxley Act, establishing the PCAOB provides, "There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." Sarbanes-Oxley Act § 101, *15 U.S.C. § 7211 (2005)*.

(n43)Footnote 43. *See* Sarbanes-Oxley Act §§ 102(a) and 102(d), *15 U.S.C. § 7212 (a), (d)*.

(n44)Footnote 44. *See* Sarbanes-Oxley Act § 103(a), *15 U.S.C. § 7213(a)*. The outside auditor's report on internal control over financial reporting is discussed in § 14.08[5] below.

(n45)Footnote 45. *See* Sarbanes-Oxley Act § 103(a), *15 U.S.C. § 7213(a)*.

(n46)Footnote 46. *See* Sarbanes-Oxley Act § 104(a), *15 U.S.C. § 7214(a)*.

(n47)Footnote 47. *See* Sarbanes-Oxley Act § 104(a), *15 U.S.C. § 7214(a)*.

(n48)Footnote 48. *See* PCAOB Auditing Standard No. 3 (June 9, 2004), PCAOB Auditing Standard No. 4 (Feb. 6, 2006), PCAOB Auditing Standard No. 5 (July 27, 2007), and PCAOB Rules 3520-3524 (April 19, 2006).

(n49)Footnote 49. *See* Sarbanes-Oxley Act § 105, *15 U.S.C. § 7215*.

(n50)Footnote 50. *See* Sarbanes-Oxley Act § 105(c)(4), *15 U.S.C. § 7215*.

(n51)Footnote 51. *See* Sarbanes-Oxley Act § 105(c)(4), *15 U.S.C. § 7215*.

(n52)Footnote 52. *See* Sarbanes-Oxley Act § 105(c)(5), *15 U.S.C. § 7215*. Determining how accounting firms can avoid the PCAOB's scrutiny encourages a review of Rule 102(e) of the SEC's Rules of Practice and the resulting case law. A survey of recent cases under Rule 102(e) exposes the fact that the SEC generally brought proceedings where the accountant had a stake in the outcome of the transaction and either (1) committed fraud for its own advantage or profit, (2) committed accounting fraud by consciously treating a transaction in a manner it knew or should have known to be in violation of GAAP and not supported by GAAS, or (3) committed malpractice by a gross departure from professional standards.

(n53)Footnote 53. *See* Sarbanes-Oxley Act § 404(b); Regulation S-K Item 308(b), *17 CFR § 229.308(b) (2009)*; Regulation S-X Rule 2-02, *17 CFR § 210.2-02 (2009)*. Management's report on internal control over financial reporting is discussed in §14.02[2][d][iv] above.

(n54)Footnote 54. *See* Sarbanes-Oxley Act §§ 103(a) and 404(b). The PCAOB's Auditing Standard No. 2 was approved by the SEC on June 17, 2004.

(n55)Footnote 55. According to Auditing Standard No. 2, an "audit of internal control over financial reporting" (the term that is used throughout Auditing Standard No. 2) refers to the "attestation" process required pursuant to Section 404 of the Sarbanes-Oxley Act. The PCAOB's Auditing Standard No. 2 requires an "audit" of internal control over financial reporting that must be integrated with the outside auditor's audit of the company's financial statements.

(n56)Footnote 56. *See* PCAOB Auditing Standard No. 5 PP 85-86 (July 27, 2007).

(n57)Footnote 57. The terms "significant deficiency" and "material weakness" are described in § 14.02[2][d][i].

(n58)Footnote 58. PCAOB, *Board Approves New Audit Standard For Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule*, (May 24, 2007).

(n59)Footnote 59. PCAOB, *Staff Views, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*, (Jan. 23, 2009). In response to concerns over the impact of the implementation costs of Sarbanes-Oxley Section 404 compliance, the SEC repeatedly postponed the compliance deadline for non-accelerated filers. Only in 2009 were small filers required to comply with Section 404(a), management's assessment of internal controls. The deadline for compliance with Section 404(b)'s requirement of an attestation of internal control has been postponed to filings covering fiscal years ending on or after December 15, 2009. Industry opinion was that additional extensions of that deadline are now unlikely, given Chairman Schapiro's comments on the topic during her confirmation testimony: "It's time that we bring uniformity to the system."

(n60)Footnote 60. The SEC and the PCAOB worked to harmonize Accounting Standard No. 5 with the SEC's revised rules governing management's evaluation of effectiveness over internal controls issued at the same time. In particular, the definitions of "significant weakness" and "material weakness" were standardized. The SEC rules are described in §§ 14.02[2][d][ii] and 14.02[2][d][iii] above.

(n61)Footnote 61. Nevertheless, the standard requires the auditor to evaluate all deficiencies that are identified and communicate both material weaknesses and significant deficiencies, in writing, to the audit committee.

(n62)Footnote 62. PCAOB, *Board Approves New Audit Standard For Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule*, (May 24, 2007).

(n63)Footnote 63. PCAOB Auditing Standard No. 5 P 85 (July 27, 2007).

(n64)Footnote 64. *See* PCAOB Auditing Standard No. 5 P 85 (July 27, 2007).

(n65)Footnote 65. PCAOB Auditing Standard No. 5 PP 9-13 (July 27, 2007).

(n66)Footnote 66. *See* PCAOB Auditing Standard No. 5 PP 14-15 (July 27, 2007).

(n67)Footnote 67. PCAOB Release No. 2007-005, at 5 (May 24, 2007).

(n68)Footnote 68. *See* PCAOB Auditing Standard No. 5, P 17 (July 27, 2007).

(n69)Footnote 69. *See* PCAOB Auditing Standard No. 5 PP 75 (July 27, 2004).

(n70)Footnote 70. *See* PCAOB Auditing Standard No. 5, P 79 (July 27, 2007).

(n71)Footnote 71. *See* PCAOB Auditing Standard No. 5, P 80 (July 27, 2007).

(n72)Footnote 72. *See* PCAOB Auditing Standard No. 5, P 81 (July 27, 2007).

(n73)Footnote 73. *See* PCAOB Auditing Standard No. 5, P 80 (July 27, June 12, 2007).

(n74)Footnote 74. *See* PCAOB Auditing Standard No. 4 (Feb 6, 2006), amended by Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements (July 27, 2007).

(n75)Footnote 75. *See* PCAOB Auditing Standard No. 4 (Feb. 6, 2006), amended by Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements (July 27, 2007).



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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

2-15 Corporate Governance: Law and Practice 15.syn

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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

2-15 Corporate Governance: Law and Practice § 15.01

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§ 15.01 General Considerations Surrounding Executive Compensation as a Corporate Governance Issue

[1] Importance of Executive Compensation in Corporate Governance

The field of corporate governance is concerned with the balance of power among corporate executives, directors, shareholders, and other constituents. A central problem of corporate governance is the so-called agency problem--the "divergence of interest between ownership and control."¹

The agency problem finds stark expression in the area of executive compensation. A self-interested manager wants as much money as possible.² The shareholders' interest is not necessarily in minimizing the compensation paid to corporate executives but, rather, in *optimizing* the level of executive compensation (that is, in setting the executive compensation at a level that maximizes the net value to the corporation) and in arranging for the compensation to be paid on terms and conditions that maximize its positive effect on corporate performance and in particular on shareholder value.

[2] Increasing Focus on Executive Compensation Excesses--The 2008 Financial Crises and Collapse of Credit Markets

In the decade leading up to the financial crises that began in 2008, perceived abuses of executive compensation commanded the attention of the business press and the popular press alike and attracted vocal criticism from shareholder activists, institutional investors and policymakers. Among the more infamous of such abuses were payments to former Disney President Michael Ovitz;³ former Tyco CEO L. Dennis Kozlowski;⁴ former WorldCom CEO Bernie Ebbers;⁵ and former Enron executives Kenneth Lay and Jeffrey Skilling.⁶ While newsworthy, these abuses were largely muted by the general prosperity experienced by Wall Street as well as everyday investors in the markets.

The legal and regulatory reform⁷ movement predating the 2008 fiscal crises included, but was not limited to, the SEC's adoption of expanded proxy disclosure obligations and the passage of a new section of the Internal Revenue Code ("*IRC Section 409A*") with tax rules and penalties on deferred compensation not meeting certain requirements, as included in the American Jobs Creation Act of 2004, as well as increased involvement of institutional and other shareholders particularly in the form of shareholder proposals concerning executive compensation issues. Other pre-2008 financial

crises "reforms" included a growing sense of independent responsibility among board compensation committee members, with a concomitant increase in reliance on independent compensation consultants and legal counsel working directly with board compensation committees (rather than through executive management); and the publication by influential business groups of "white papers" on the subject of executive compensation as a corporate governance issue.⁸

The compensation landscape changed significantly in 2008 as regulators, lawmakers and activists acted in a myriad of ways to address the deepest economic crisis since the Great Depression. In search of the culprits in the global financial meltdown, bloated executive pay and the excessive risk-taking it fueled stood out as prime suspects. In one year, Congress, the SEC, the Treasury Department, the Federal Reserve, and other government agencies and influential shareholder advisory advisors have played unprecedented roles in shaping the confines of executive pay, director elections and other governance issues.

The different forms of executive compensation, as well as the pay mix under various circumstances, will be discussed in detail in this chapter, along with discussion of how the new regulatory environment has influenced pay mixes and decision-making. Appendix 15-B contains a glossary of most of the terms and forms of compensation discussed herein.⁹

[3] New Rules and Restraints--Overview of the Regulatory Evolution

While Chapter 10 will cover in more detail the technical aspects of the regulatory evolution that followed the financial crises, the following summarizes the most important aspects of either pending or adopted restrictions that have set the tone for many compensation decisions following the economic crises. This chapter elaborates on how many of these new constructs are shaping traditional compensation consulting and recommendations.

[a] SEC Issues Amendments to Disclosure Rules:

Prompted at least in part by the continuing economic crises, in the summer of 2009, the SEC voted to propose new rules that would require companies to disclose more information on compensation risks, other services performed by compensation consultants that may result in perceived conflicts, director qualifications and board leadership structures. The SEC initiatives also include a rule change on the disclosure of equity compensation. In the Summary Compensation Table, companies would be required to report the aggregate grant date value of equity compensation awarded during the year, rather than the current method of reporting the annual accounting expense accrual under FAS 123R. The grant date value would reflect the full number of shares or options that could vest, effectively resulting in inclusion of maximum grant date award values for performance-based equity awards.¹⁰

[b] Passage of EESA, TARP and ARRA:

The Troubled Asset Relief Program (TARP), was established pursuant to the Emergency Economic Stabilization Act of 2008 (EESA)¹¹ (later amended by the American Recovery and Reinvestment Act of 2009 (ARRA)¹²), to give the U.S. Department of the Treasury broad authority to purchase and insure mortgage assets and other financial instruments to promote financial market stability. Companies that received federal assistance under this program were obligated to comply with certain executive compensation restrictions and corporate governance standards, as follows:

- Incentive compensation must not encourage unnecessary and excessive risks that could threaten the value of the institution, and an extensive certification by the CEO and CFO as to review of risk in compensation plans is required.
- Bonus payments (except for limited restricted stock awards) are prohibited for anywhere from 1 to 25 highest paid executives (HCEs), depending on the amount of TARP funds received.

- "Clawbacks" are required for the named executive officers (referred to as CEOs) and next 20 (HCEs) where incentive compensation was based on statements later found to be materially inaccurate.
- Severance payments for the CEOs and next 5 HCEs are prohibited.
- Tax gross-ups for the CEOs and next 20 HCEs are prohibited.
- The section 162(m) deduction is limited to \$500,000, with no exceptions for performance-based pay.¹³
- Enhanced disclosure about perquisites and establishment of luxury expenditure policies are required.
- A "Say on Pay" non-binding advisory vote on executive compensation is required.

In addition, an Office of the Special Master for TARP Executive Compensation (also known as the "compensation czar") was established to oversee executive compensation for companies that have received or are receiving TARP assistance.

While these restrictions are required only of companies that have received TARP assistance, the standards have set the tone for a broader trend in executive compensation. Specifically, policies related to limiting (or clearly assessing) risk in compensation plans, clawbacks, and scaling back severance and tax gross-up payments and other perquisites are but a few of the TARP restrictions anticipated to spill over into policies of non-TARP companies, and likely to become viewed as best practices, at least until the economy recovers.

[c] H.R. 3269 (the Corporate and Financial Institution Fairness Act)

A major step toward mandatory Say on Pay and other significant regulatory reform was taken in the summer of 2009 when the House passed H.R. 3269 (the Corporate and Financial Institution Fairness Act). This bill would provide for:

- **Say on Pay: Annual Shareholder Approval of Executive Compensation:** All public companies must give their shareholders an annual, non-binding vote on executive compensation matters disclosed in the proxy statement for named executive officers, including the Compensation Committee Report, the CD&A, the compensation tables and any related materials.
- **Shareholder Approval of Golden Parachute Arrangements:** In the event of a change-in-control transaction (such as an acquisition, merger or substantial asset sale requiring shareholder approval), shareholders of public companies must be given a non-binding vote on any compensation agreements related to the transaction with named executive officers. This information must be provided in the proxy statement seeking shareholder approval of the transaction in a "clear and simple form."
- **Compensation Committee Independence**
 - **Stricter Standards of Independence for Members:** To be considered independent, committee members cannot accept any consulting, advisory, or other fees from the company other than pay received for their board service.
 - **Compensation Consultants:** Any compensation consultant retained by the committee must be independent under standards to be established by the SEC.

- Disclosure: Companies must disclose in their proxy materials whether the committee has retained a compensation consultant meeting SEC standards for independence.

- **Enhanced Reporting and Regulation of Compensation Incentives at Financial Entities:** The proposed legislation would give the federal regulators enhanced powers to regulate compensation of certain financial entities where it considers compensation to be tied to excessive risk-taking.

[4] Compensation Decisions in a Say on Pay Environment

With Say on Pay likely to be required for all public filers by 2011, it is important to understand both the action steps and rationale for such a process. Proponents of Say on Pay argue that an advisory vote will give shareholders an effective mechanism to express dissatisfaction with a company's executive compensation practices, similar to the voting mechanisms already in place in the UK. Critics respond that Say on Pay has significant shortcomings, among them, that holding an up/down referendum on highly complex executive compensation programs will give corporate boards little practical insight into shareholders' views on pay. They also are concerned that investors may lack the expertise or inside company information needed to appropriately evaluate pay decisions for individual executives.

It is important to take proactive steps in advance of the impending new requirement, including the following:¹⁴

Knowledge

- Make sure the committee is making pay decisions today in the context of the upcoming Say on Pay vote.
- Determine whether committee members are comfortable taking a position that differs from "best practices" recommendations if they believe such recommendations may not make sense for the company.
- Understand institutional shareholders' views on Say on Pay and whether they are likely to follow recommendations from proxy advisory firms like RiskMetrics Group (referred to herein as RMG, and formerly known as ISS).
- Stay abreast of the results of Say on Pay proposals at other companies.
- Partner internally with investor relations, legal and senior management on a multi-disciplined approach toward Say on Pay. Also draw upon the experience and expertise of external advisors across the various disciplines.

Disclosure

- Review the proxy CD&A and related tables to ensure executive compensation disclosure is clear, complete, and not open to misinterpretation. Consider whether the proxy disclosure is consistent with other public documents (such as the company's 10-K, annual report, press releases, etc.), especially with respect to key business goals, risks, and competitors.

Program Review

- Identify any perceived "problematic pay practices" in the company's executive compensation philosophy and program design.
- Review market benchmarking practices, particularly with respect to selection of appropriate peer

groups.

- Conduct an analysis to ensure there is a strong link between executive pay and performance over multiple long-term time horizons.
- Conduct a risk assessment to ensure that incentive programs do not motivate "unnecessary and excessive risk-taking." Consider additional checks and balances such as caps on bonus payouts and clawback provisions.
- Consider the use of stock ownership/retention guidelines to strengthen the long-term alignment between executives and shareholders.
- Establish a plan for any changes to the compensation program resulting from the program review, including what changes should be made, when changes will be implemented, how changes will be communicated to employees and any relevant external parties, etc.
- Articulate the company's rationale for any perceived "problematic pay practices" that the company has decided not to change and develop an approach for addressing investor questions, should concerns arise.

Shareholder Outreach

- Establish an effective shareholder communication strategy, including a process for gathering feedback on executive compensation programs. Consider how to differentiate the approach for the company's top 20 institutional shareholders.
- Establish a strategy for communicating with employee shareholders, including unions where applicable.
- Review the company's bylaws to determine how abstentions would count in a Say on Pay vote. Abstentions can be a determining factor in vote outcomes, but changing the bylaws on abstentions could negatively affect other types of shareholder votes.
- Despite the visibility of Say on Pay and the benefits of the proactive steps outlined above, common sense still suggests that sustained, superior performance can offset the concerns of most shareholders.

Process in Advance of SEC Rules

Either new federal legislation or SEC regulation will ultimately determine what form Say on Pay will take in the U.S. TARP companies are required to have an annual, non-binding Say on Pay vote that covers the compensation of the executives, as disclosed pursuant to the compensation disclosure rules of the SEC, including the compensation discussion and analysis ("CD&A"), the compensation tables and any related material disclosed in the proxy statement.

To date, non-TARP companies are not racing to put Say on Pay on the proxy ballot. Most companies are waiting for Say on Pay to become mandated, rather than implementing Say on Pay in a format that would ultimately be changed to conform to new regulations.

Non-TARP companies that have already voluntarily adopted Say on Pay have taken a variety of approaches. The areas where voluntary Say on Pay proposals differ include:

- (A) frequency of the Say on Pay vote,
- (B) whether it is a single "yes/no" vote,
- (C) what elements of pay are actually being put to a vote,
- (D) the nature and extent of management's statement about the vote, and
- (E) whether the company has made any statement concerning what action the it might take if there is a negative Say on Pay vote against management.

(A) Frequency of Vote

An annual, non-binding Say on Pay vote is supported by pending legislation (House of Representatives: Shareholder Empowerment Act and Senate: Shareholder *Bill of Rights* Act of 2009) as well as the June 10, 2009 White House proposals. However, some institutional investors and shareholders are concerned about the burden of analyzing and voting on the pay at thousands of public U.S. companies, most of which file their proxy statements within a two-month window. By contrast, there are considerably fewer public companies in each of the other countries where Say on Pay has already been mandated. The various approaches that have been adopted to date include:

- annual vote (AFLAC Inc.)
- biennial vote (every other year; Prudential Financial, Inc.)
- triennial vote (every third year; Microsoft Corporation; proposed by the United Brotherhood of Carpenters Pension Fund)
- shareholder survey, no vote (Schering-Plough Corporation, Lockheed Martin Corporation, Northrop Grumman Corporation, and TIAA-CREF)

(B) One vs. Multiple Votes

Most companies that have voluntarily adopted Say on Pay are offering a single "yes/no" vote that is unlikely to help the board understand what shareholders are objecting to if there is a negative vote. As of the date of this writing, only a few have companies instituted multiple votes that address specific parts of the compensation program and decisions.

RMG's three-part Say on Pay vote was noteworthy because of that organization's position of influence as a proxy advisory firm. RMG offered shareholders a non-binding advisory vote on three aspects of pay and also indicated that its board compensation committee "will take into account the outcome of the vote when considering future executive compensation arrangements." The three vote resolutions are generally:

- approval of the company's overall executive compensation philosophy, policies and procedures, as described in the CD[A]
- approval of the compensation decisions made by the board with regard to Named Executive Officer performance for the previous (completed) year, as described in the CD[A] and
- approval of the application of the company's compensation philosophy, policies and procedures to evaluate the current (in progress) year's performance of, and award compensation based on, certain key objectives, as described in the CD&A.

This format is unlikely to gain popularity among public companies, particularly since the third resolution is predicated on full disclosure of the payout opportunities and performance goals for the current year that is in progress. Although the SEC continues to push for full disclosure of incentive plan performance targets, companies are intensely concerned that competitive harm could result from such disclosures. In some cases, there is potential for harm even after the performance period has been completed and the payouts have been made, e.g., business unit financial or operating performance results/goals that are not otherwise transparent to shareholders through segment reporting.

It would be possible to put each pay element to a vote separately (philosophy, peer group, salary, bonus, equity awards, etc.) in order to gain more specific information about what shareholders may not like about the compensation program. However, this borders on asking shareholders to micromanage the compensation program, is potentially cumbersome, and has the risk of an extremely negative outcome if each of the separate votes is "lost."

(C) What Shareholders Are Voting On

Pending SEC regulation, non-TARP companies may decide what shareholders are being asked to vote on. For example, the Say on Pay vote could allow shareholders to vote on the compensation philosophy, the compensation policies and procedures, the past year's program design, the current or coming year's program design, the actual compensation amounts awarded to the proxy officers in the past year, the amount of compensation opportunity that is offered to the proxy officers, the CD&A, the Summary Compensation Table, and/or the related proxy tables. A few companies have tried to focus on the compensation philosophy, policies and procedures, while being careful to avoid a direct vote on the actual compensation amounts. A comparison of the Say on Pay language for Microsoft Corporation and AFLAC Inc. illustrates this point:

Microsoft Corporation

"Accordingly, the Board of Directors proposes that you indicate your support for the Company's compensation philosophy, policies, and procedures and their implementation in fiscal year 2009 as described in the Compensation Discussion and Analysis section of this Proxy Statement."

AFLAC Inc.

"Resolved, that the shareholders approve the overall executive pay-for-performance compensation policies and procedures employed by the Company, as described in the Compensation Discussion and Analysis and the tabular disclosure regarding named executive officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement."

In several cases, the company initially received a shareholder proposal to adopt Say on Pay that was included in its proxy statement. Although management and the board opposed the shareholder proposal, it may have passed with a majority. If there is subsequently a management Say on Pay proposal, the company should consider the language of the shareholder proposal when developing the management proposal.

Despite the time spent on crafting the exact language of the Say on Pay vote, many shareholders, including institutional investors, are not making much distinction when casting their votes.

(D) Scope of Management's Statement

Management statements in the proxy filing that encourage shareholders to vote in favor of the management Say on Pay proposal range from a brief reference to the other relevant sections of the proxy to a substantive discussion of the compensation philosophy and the key reasons to support management's position (e.g., about 200 to 700 words in length). Unlike TARP companies, the non-TARP companies have had more time to consider the wording of management's statement and are typically highlighting key shareholder-friendly aspects of the compensation program

(which might otherwise be overlooked in a lengthy CD&A), without providing so much detail that it is either duplicative or seemingly apologetic.

(E) Reference to Action Following a Negative Vote

Only a few of the companies with Say on Pay votes provided any discussion of what actions, if any, would be taken if the non-binding vote were to be negative/against management. Examples of management statements about how the results of the Say on Pay vote will affect compensation include:

H&R Block, Inc.: "Because your vote is advisory, it will not be binding upon the Board. However, the Compensation Committee will take into account the outcome of the vote when considering future executive compensation arrangements."

Microsoft Corporation: "Although the vote is non-binding, Board and the Compensation Committee will review the voting results. To the extent there is any significant negative say-on-pay vote, we would consult directly with shareholders to better understand the concerns that influenced the vote. The Board and the Compensation Committee would consider constructive feedback obtained through this process in making future decisions about executive compensation programs."

Of course, Microsoft does not specify what percentage of negative votes would be considered "significant." There is some debate regarding what level of votes against management is a "call to action" that cannot be ignored even if the vote is non-binding. At a minimum, if there is a majority vote against management, institutional investors like CalPERS expect action by the compensation committee and the board. If a company takes no action and is considered to be "tone deaf," the likelihood of a withhold vote campaign against the members of the compensation committee is quite high.

Our first-year experience with TARP companies that were required to implement Say on Pay in 2009 showed that 100 percent of the management proposals passed. Moreover, the majority passed with 90 percent or higher votes for management. Only about 5 percent of the management proposals passed with under 70 percent of the votes. As institutional investors and proxy advisory firms study this information, companies should not assume that passing with 50.1 percent of the vote will be sufficient to avoid a withhold vote campaign against the members of the compensation committee. In the UK, where Say on Pay has been mandated since 2002, the voting results are more tightly grouped. Some UK advisors would even consider passing with 90 percent of the votes to be a problem. Companies should also be aware that the media, RMG and others may only be considering the "For" votes as a percentage of the votes cast ("For" plus "Against"). Thus, abstentions are not considered, regardless of how an "Abstain" is required to be counted in each company's bylaws.

Proxy Advisory Firms

There is concern among public companies that the advent of mandatory Say on Pay will result in an undue increase in the power and influence of proxy advisory firms, particularly RMG. Mid-tier institutional investors who may not have their own teams of compensation research analysts tend to rely heavily on RMG. In some cases, an investment analyst may not be allowed to diverge from the RMG vote recommendations without bringing the matter to their firm's investment committee. As such, it would be unlikely that an investment analyst will take a contrary position in favor of management. The larger investment firms have their own independent research, but most still subscribe to various reports from the proxy advisory firms.

An emerging theme is that a company will be targeted by the proxy advisory firms and/or institutional investors if it is an outlier with respect to pay-for-performance misalignment or based on the presence of "problematic pay practices." The RMG voting policy manual lists several problematic pay practices, including change-in-control excise tax gross-ups offered to new executives or in materially amended agreements for existing executives. Fidelity and other

institutional investors also disclose their voting policies, although they do not all contain specific lists of problematic pay practices, nor are they all focused on the same problematic pay practices.

For 2010, RMG describes a two-step voting method on compensation-related recommendations whereby a negative vote on the management Say on Pay proposal would generally be the first action taken and withhold votes on the compensation committee could follow in the subsequent year if issues raised in the first year are still ongoing. Of course, RMG may still immediately recommend votes against directors if egregious pay practices are identified and/or if there is no management Say on Pay proposal on the ballot. In rare cases, RMG has also recommended votes against the entire board based on egregious issues with a company's compensation practices (for example, pervasive and ongoing problematic pay practices). Institutional investors have also been considering a two-step approach for management Say on Pay votes and director withhold votes as they define their voting policies in preparation for mandatory Say on Pay in the U.S.

Changes in Proxy Disclosure

The proxy CD&A remains the primary method of communication with all shareholders about compensation matters. U.S. companies across industries are already beginning to prepare for mandatory Say on Pay by making changes to their proxy disclosures, regardless of whether they are making any changes in compensation program design. The length of an average proxy CD&A section runs over 5,400 words and the pending SEC disclosure rules are likely to result in additional text. As such, it may be difficult for shareholders to pick out the information needed to form an opinion on the Say on Pay proposal. Furthermore, despite company efforts to provide "plain English" disclosures, many proxy CD&As read more like a legal document than a news flash. With Say on Pay looming, companies are starting to redraft the proxy CD&A from a marketing perspective. An emerging trend is to provide an overview of key compensation decisions and changes, along with the committee's supporting rationale, at the beginning of the CD&A. Companies are also highlighting policies that are likely to garner points on a best practices checklist, for example, the committee's retention of an independent compensation consultant who does not perform work on behalf of management, stock ownership guidelines for executives and directors, recovery or claw back of incentives if an executive has engaged in misconduct, and elimination of perquisites and tax gross-up provisions. The more that can be done to clarify the company's pay-for-performance alignment, the better.

Shareholder Outreach

Although outreach to major institutional investors and advisory groups is a regular aspect of the Say on Pay process in the UK, it is not clear whether shareholder outreach will play as significant a role in the U.S. At a minimum, U.S. companies are subject to Regulation FD, which prohibits companies from making selective disclosures to some investors and not others.

Interestingly, a survey of 231 companies¹⁶ suggests that just 6 percent of respondents said their company is "very concerned" about the prospects for Say on Pay, with another 35 percent describing themselves as "somewhat" concerned. Particularly since none of the TARP companies failed their Say on Pay votes, many companies do not seem to have focused on increasing shareholder outreach on compensation issues. For example, 87 percent of the survey respondents from TARP companies said they are not reaching out to shareholders any more often about executive pay issues than before Say on Pay was mandated. Non-TARP companies were also quite confident about Say on Pay:

- 76 percent of non-TARP firms indicated they think shareholders would vote in favor of their executive compensation program if a Say on Pay vote took place currently.
- 46 percent said that, at present, they "never" seek shareholder input on executive pay matters and fewer than 7 percent conduct shareholder outreach more than once a year.

- However, 62 percent of non-TARP firms said they will increase their outreach efforts if Say on Pay becomes mandatory.

On the other side, institutional investors and advisory groups may not be prepared to handle increased shareholder outreach efforts by significant numbers of U.S. companies. Even logistically, their investment analysts and research staff are too busy to accommodate meetings or private conferences with thousands of public companies, particularly during the proxy voting "season." For example, institutional investors may only speak to "problem" companies and/or large companies where they have significant investments. Thus, when pursuing shareholder outreach, it is advisable to begin a dialogue on important compensation issues outside of proxy voting season.

Overall, regardless of whether Say on Pay is a useful tool or seriously flawed, it is likely to become mandatory for U.S. companies in the near future. While a company may not choose to become an early adopter of Say on Pay, it is prudent for the compensation committee to get prepared. The bottom line is that the committee's compensation decisions should be able to pass muster with shareholders, even if it is demonstrated through a single, yes/no Say on Pay advisory vote.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Compensation Bonus & Severance Pay Business & Corporate Law Corporations Directors & Officers Compensation Salaries Tax Law Federal Income Tax Computation Deductions for Business Expenses Business, Entertainment & Trade Expenses (IRC secs. 162, 274) Tax Law Federal Income Tax Computation Retirement Plans Rollovers, Vesting & Mergers (IRC secs. 401, 408-409, 411)

FOOTNOTES:

(n1)Footnote 1. Adolf Berle & Gardiner Means, *The Modern Corporation and Private Property*, 112-19 (1932) (Transaction Publishers Edition, 2002).

(n2)Footnote 2. This is not to suggest, of course, that most or all corporate executives are entirely self-interested or do not have a keen sense of their duties to others, including shareholders. It is, rather, a description of the purely self-interested component of an executive's motivation in regard to compensation.

(n3)Footnote 3. See B. Orwall and Merissa Marr, *Judge Backs Disney Directors in Suit on Ovitz's Hiring, Firing*, Wall St. J., Aug. 10, 2005, at A1.

(n4)Footnote 4. See M. Maremont, *Tyco Figures Will Be Jailed at Least 7 Years*, Wall St. J., Sept. 20, 2005, at C1.

(n5)Footnote 5. See D. Ackerman, *Bernie Ebbers Guilty* Forbes.com, Mar. 15, 2005.

(n6)Footnote 6. See *The Enron Verdict: The Experts Speak*, Wall St. J., May 25, 2006.

(n7)Footnote 7. See, e.g., Chapter 16 below.

(n8)Footnote 8. See, e.g., Business Roundtable, *Executive Compensation: Principles and Commentary* (Nov. 2007) (reproduced in full as Appendix 15-A to this chapter); Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee (2007); The Conference Board, *The Evolving Relationship Between compensation committees and consultants* (Jan. 2006).

(n9)Footnote 9. See, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee (2007): the Annotated Glossary to this NACD report is reproduced in full as Appendix 15-B to this chapter.

(n10)Footnote 10. *See*, 17 CFR Parts 229, 239, 240, 249, 270 and 274 (Proxy Disclosure and Solicitation Enhancements; Proposed Rule, July 17, 2009).

(n11)Footnote 11. Public Law 110-343

(n12)Footnote 12. Public Law 111-5

(n13)Footnote 13. *See* Chapter 10, § 10.06[4].

(n14)Footnote 14. *See* PM&P Trends and Issues Report: Top 10 Executive Compensation Issues in the New Economy (April 2009).

(n15)Footnote 15. *See* PM&P Trends & Issues Report: The 2009 Early 50 Filers (survey analyzing proxy statements of the first 50 public companies to file in 2009).

(n16)Footnote 16. *See* PM&P 2009 Say on Pay Survey (September 2009).



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Corporate Governance: Law and Practice

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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

2-15 Corporate Governance: Law and Practice § 15.02

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§ 15.02 Determining the Overall Level of Executive Pay

[1] The Upper Limits of Executive Compensation

Allegations of excessive executive pay form the basis of shareholder derivative lawsuits as well as challenges by the Internal Revenue Service ("IRS") to tax deductibility of compensation. Historically, shareholders have not prevailed in such lawsuits,ⁿ¹ but in the post-Enron era, courts became more receptive to shareholder charges of excessive executive compensation.ⁿ² This receptivity is expected to continue in the years following the financial meltdown of 2008. Once a lawsuit is filed, a compensation consulting firm may be retained as an expert witness to provide a reasonableness opinion. The expert's opinion typically is based on an examination and evaluation of several factors:

- executive qualifications and earnings capacity;
- executive availability;
- characteristics of the enterprise (such as size, complexity and circumstances);
- difficulty of meeting business challenges;
- results achieved (such as growth in revenues or profits, total shareholder return or other appropriate measures); and
- competitive industry benchmarks.

The compensation committee's determination of the overall level of executive pay should also be based on these as well as additional factors, some of which are specific to the company. Consider, for example:

- If a company pays its executives at the industry median, is the pay always reasonable? What if the entire pay package is in the form of salary--fixed pay that has no link to performance? What if the company is the worst performer in the industry?

- If a company pays its executives at the industry 75th percentile, is the pay necessarily excessive? What if the company's compensation philosophy is to deliver superior results by hiring "the best and the brightest," rather than the average performer?
- If a company pays its executives more than any other company in the industry, is the pay always excessive? What if the company significantly outperforms the industry on a consistent basis?

Compensation programs not linked to performance for shareholders and those that generate compensation levels inconsistent with performance on a relative basis are likely to be considered unacceptable. The compensation committee also must monitor the reasonableness of the compensation programs over time and in the context of the company's compensation philosophy. For example, an annual bonus plan that smoothes payouts through a deferral or banking mechanism could be appropriate for a cyclical industry, but this design deliberately will pay "too much" in bad times and "too little" in good times, in order to dampen the impact of general market fluctuations beyond the executive's control.

The mix of pay elements, the demographics/characteristics of the executive population and the corporate culture are also important considerations in avoiding excessive compensation costs. Offering a high-risk, leveraged program (for example, potential bonus from zero to 300 percent of salary) to a risk-averse, long-tenured executive group could promote an entrepreneurial culture, but the overall compensation levels might need to be higher than if the company were to offer a pay mix more common in traditional, mature industries (for example, a potential bonus from zero to 100 percent of salary). In contrast, private companies that do not offer equity or phantom equity incentives might have to pay higher cash compensation to attract the young entrepreneur.

Shareholders have a direct say in determining the level of equity compensation when they are asked to approve equity-related compensation plans.ⁿ³ While there is some debate about whether there is an optimal dilution level by company, analysis of historical data suggests that dilution levels well in excess of or substantially below industry norms are correlated with poor returns to shareholders.ⁿ⁴ In fact, RiskMetrics Group (referred to herein as RMG and formerly known as ISS) establishes guidelines for determining how much dilution is too much.ⁿ⁵

The compensation committee should annually review the overall compensation program for senior executives to ensure that the level remains appropriate in view of changed circumstances, including the performance of the company and the difficulty of attracting and retaining appropriately qualified senior executives in the current market. The committee's annual review of overall compensation levels and making changes when changed circumstances warrant them will help avoid an entitlement mentality, excessive compensation expense and, hopefully, shareholder derivative suits based on excessive compensation allegations.

[2] The Lower Limits of Executive Compensation

When executive pay is too low, the consequences include turnover, raiding by competitors, inability to hire superior candidates and difficulty in growing the business and competing effectively, particularly in service industries. However, these corporate ailments may also result from underlying problems other than below-market compensation--such as lack of opportunities for promotion, poor business fundamentals or an insufferable top executive. For this reason, executive compensation should always be considered in a broader human resources context and never in a vacuum.

Companies sometimes deliberately set target pay opportunities for executives below those of their competitors on the rationale that they offer non-monetary or "psychic" rewards not available at other companies, such as nicer offices, a superior suburban location, moderate hours, less travel, a low stress environment, more job security, and an opportunity to work on cutting edge research, a superior company reputation or a more family-friendly culture. In these situations, even if there is little executive turnover, the compensation committee should be vigilant to avoid the more insidious

costs of low pay. These include a gradual deterioration in the quality of executive talent, lack of motivation or incentive to advance (especially if there is compression in top executive compensation levels), complacency, low morale, title inflation and various efforts to "game" an inadequate incentive plan, such as distortion of the budgeting process, attempts to shift income from a "below threshold" year to the next year, frequent year-end negotiations regarding adjustments to performance metrics based on "unusual" circumstances, or using individual performance factors to guarantee a minimum incentive award.

Executive pay opportunities may also be too low if Herculean performance is required to achieve market median compensation levels. Sometimes this occurs inadvertently when absolute performance targets are used and the entire industry experiences a market downturn. Although a target incentive award might not be appropriate in that case, executives could be unduly penalized with a zero award despite performance that exceeds the industry average. If adjustments to the incentive opportunity or the performance measures are contemplated, it is important to remember that a windfall in an up market may offset the penalty in a down market.

[3] The Escalating Influence of Institutional Shareholder Advisory Services

Over the past few years, and particularly following the financial crises, institutional shareholders and those advisory services upon which institutional shareholders rely for vote recommendations have had an exponential impact on compensation decision-making among public companies. Of particular significance is the growing influence of RMG.

RMG may issue vote recommendations against compensation committee members, the CEO, an entire board and/or adoption of new equity plans depending on its analysis of the company's pay practices, so complying with their guidelines is an increasing concern among public companies. These guidelines fall in two general categories--the "pay for performance" test and the "problematic pay practice" test.

Pay for Performance Policy

Under its current policy, RMG may recommend against an equity plan and/or to withhold votes from compensation committee members if there is a disconnect between CEO pay and company performance, which is defined as: (1) total shareholder return ("TSR") over the most recent one- and three-year periods that under performs (below median) vs. the peer companies in the company's four-digit Global Industry Classification System (GICS), and (2) an increase, flat or a marginal decrease in CEO total compensation, particularly for the most recent year-over-year. Under the updated 2010 policy, RMG will also consider the company's pay-for-performance alignment over a five-year time horizon. This policy is intended to identify the worst performing companies within an industry at a time when broad market declines have affected all industries.

Problematic Pay Practices

In its policy guidelines, RMG indicates that it will vote against management Say on Pay proposals and/or vote against or withhold from compensation committee members, the CEO, and potentially the entire board if the company engages in problematic pay practices, and may also issue a vote against equity plans if the plan is a vehicle for poor compensation practices.

The following practices, while not exhaustive, are examples of problematic compensation practices that carry the greatest weight and may warrant RMG's withhold vote recommendations on a stand-alone basis:

- egregious employment contracts, including contracts containing multi-year guarantees for salary increases, non-performance-based bonuses and equity compensation;
- excessive perquisites;

- tax reimbursements or gross-ups;
- reimbursement of income taxes on executive perquisites or other payments;
- perquisites for former executives, such as car allowances, personal use of corporate aircraft or other inappropriate arrangements;
- egregious pension/SERP (supplemental executive retirement plan) payouts, including:
 - inclusion of additional years of service not worked that result in significant payouts without sufficient justification;
 - inclusion of long-term equity awards in the pension calculation;
- excessive severance or change in control provisions, including:
 - excessive change in control or severance payments, especially those with a multiple in excess of 3X cash pay;
 - change in control payouts without loss of job or substantial diminution of job duties (single-triggered);
 - new or materially amended employment or severance agreements that provide for modified single triggers, under which an executive may voluntarily leave for any reason and still receive the change-in-control severance package;
 - new or materially amended employment or severance agreements that provide for an excise tax gross-up (with modified gross-ups being treated in the same manner as full gross-ups);
- dividends or dividend equivalents paid on unvested performance shares or units;
- executives' using company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps or other similar arrangements; or
- repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender/subsequent regrant of underwater options).

For the first time, in 2010, RMG is also instituting an assessment of company policies and practices related to compensation that could incentivize excessive risk-taking, as well as factors that potentially mitigate the impact of risky incentives such as rigorous clawback provisions and robust stock ownership/holding guidelines. Most of the practices identified as "risky" are consistent with RMG's existing problematic pay practices.ⁿ⁶

Glass Lewis as well as individual institutional investors likewise have their own set of compensation-related guidelines for proxy voting. However, RMG remains the dominant shareholder advisory service behind influencing and shaping policy decisions.

[4] Heightened Scrutiny of Peer Groups and Benchmarks

The process of benchmarking compensation is a powerful tool used by most public companies to make decisions regarding overall levels of pay. With the SEC's expanded disclosure rules requiring companies to disclose "peers" against which they benchmark compensation, there has been growing concern that many companies tend to "cherry pick" peer companies that will result in the most generous payouts. To ensure that appropriate and defensible peer groups are selected, the following guidelines are often considered best practices that should result in good governance practices:⁷

- Follow a rules-based approach. Picking a peer group can be highly subjective absent a well-considered, consistent process. An appropriate approach would include identifying the factors for selection of peer companies (e.g., revenue, product/service similarity) as well as establishing appropriate parameters and tolerances to evaluate the "similarity" of each factor (e.g., 1/2 to 2 times the company's revenues).

- Select similar-sized firms. Company size often serves as a proxy for comparing job complexity and scope between executives with the same title at two different firms. Ideally, the selected parameters of the company under study (such as revenues, assets, market capitalization or number of employees) should be around the median of the peer group. Revenue generally offers the strongest correlation with pay levels, although total assets often prove more relevant for financial services industries such as banking and asset management. While market capitalization may also be an important "size" factor, companies should be careful about using it as the primary factor because its high volatility may result in annual changes to the composition of the peer group.

- Pick firms with product/service similarity. Product/service similarity is a significant predictor of both pay levels and pay practices, due to underlying industry financials, life cycles, risk profiles, transferability of executive skills, etc. Alternatively, "like" industry firms can be used if companies are mindful of any differences with direct competitors in terms of size, financial performance, choice of pay vehicles, and actual pay levels.

- Revisit the peer group annually, but avoid major overhauls. Maximizing peer group consistency over time avoids drastic swings in the compensation data, better illuminates emerging compensation trends, and demonstrates that firms were not cherry-picked to produce favorable comparisons. If a major overhaul is necessitated by significant changes in size, merger and acquisition activity, or other factors, it should be based on the same rules-based approach used in the initial selection process. Leniency may be exercised for "borderline" companies that are just outside the group's revenue or market capitalization criteria.

- Be cautious about including non U.S.-based firms. Inclusion of foreign-based companies in the peer group may be warranted in some cases. There have been rapid changes in terms of disclosure and regulations outside the U.S., and executive portability is increasing. However, inclusion of foreign-based companies is complicated by multiple factors: data still is generally less available in most countries outside the U.S.; the labor market for top U.S. executives remains generally U.S.-based; and other countries' pay practices can vary dramatically because of local customs, regulations and requirements.

- Include 10-20 firms in the peer group. RMG has found that 57 percent of S&P 1,500 companies have between 10 and 20 companies in their peer group, which is generally sufficient to minimize the impact of outliers when analyzing market data. A much larger group is often less comparable in size and industry and results in significant additional expense for data collection, while a much smaller peer group may not provide adequate data to reach valid conclusions.

- Consider the peer group put together by RMG and other proxy advisory firms. For its annual Proxy

Research Reports, RMG creates a peer group for each company that is used as the basis for its compensation analysis and proxy voting recommendations. RMG's peer groups usually consist of 8 to 12 firms, based generally on revenue and the General Industry Classification Standard (GICS) code. RMG's methodology may not provide an appropriate group if a company lacks a sufficient number of similarly sized peers within its GICS code. However, given the advisory firm's voting influence, companies should at least be aware of RMG's peer company choices in putting together their own peer groups.

[5] The Growing Importance of Optics

In addition to ensuring that pay programs are competitive and effective, there is a new focus--particularly in times of economic crisis--on program "optics." The perspective of shareholders has never been more acute, given significant reductions in shareholder wealth, outrage over executive compensation at many financial services organizations receiving government bailouts, and growing support for giving shareholders a direct voice on compensation programs via a Say on Pay proxy vote. Employees' perceptions also become critical when organizations take such steps as reducing their workforce, eliminating salary increases, and reducing 401(k) benefits.

Compensation committees have been faced with the challenge to eliminate any design features that are not justifiable and to address elements that, while appropriate, are at risk of being criticized--all without sacrificing the compensation program's competitiveness or effectiveness. This is best accomplished by taking a holistic perspective and doing what is right for a particular business, rather than "following the herd." The following seven practices are being used by committees to enhance program optics:⁸

- **Minimization of perquisites.** Executive perquisites are a very small percentage of total compensation value, but a huge driver of shareholder and employee dissatisfaction. Many companies are eliminating executive perquisites that generally lack a legitimate business purpose and that other employees must cover on their own, such as personal use of a corporate aircraft; company cars and drivers; car allowances or company cars; club dues; and tax preparation services. In contrast, executive perquisites with a potentially legitimate business justification include business use of a corporate aircraft; a home security system; or a periodic physical exam.
- **Minimization of tax gross-ups.** Paying an executive's tax bill will never be viewed positively by shareholders or employees. Moreover, gross-up provisions incurred when change-in-control payments trigger excise taxes can entail significant added expense to the company. Going forward, it would be prudent for companies to avoid the use of gross-ups, with the possible exception of relatively new executives who stand to be significantly hurt by the excise tax "penalty" because their base amount, or five-year W-2 compensation with the company, is artificially low, while the value of their accelerated equity vesting may be artificially high, especially if they have received inducement equity awards at hire with limited time for exercise or vesting.
- **Rationalization of severance.** Executive-level severance is now the veritable poster child for egregious compensation. While severance has a legitimate purpose, companies always should carefully review eligibility, potential payouts, and the conditions under which severance would be provided. To ameliorate concerns about severance programs, more companies are excluding executives at later stages in their careers from eligibility for severance benefits, reducing benefit formulas and levels, and redefining contract terms such as "Cause," "Change-in-Control," and "Constructive Discharge." A challenging case that should be addressed is abysmal performance that falls short of the definition of "Cause."
- **Performance of "dynamic pay modeling."** The best way to avoid embarrassing compensation optics is to incorporate a forward-looking analysis in the program design process. Reviewing potential

outcomes under various performance scenarios at the time the program is being adopted helps avert "surprises" when compensation is earned, delivered, or disclosed.

- Embracing transparency. The litmus test for any compensation decision is whether it will withstand the light of day when reported in the proxy statement CD&A. By embracing full transparency and considering disclosure implications at the time decisions are made, optics issues can be minimized.

- Improving shareholder relations. Including shareholder outreach in the executive compensation process can help avert negative reaction to formal compensation disclosures. We recommend engaging in regular dialogues with large shareholders to increase their understanding of compensation programs, particularly in advance of a management request for authorization of additional shares for equity compensation plans or a Say on Pay shareholder vote. While mandated Say on Pay is likely in the near future, it is a blunt instrument and not a substitute for proactive communications with key shareholders on executive compensation issues.

- Retention of independent and experienced consultants. In a rapidly changing environment, a seasoned executive compensation consultant adds value and credibility to the compensation process. Given the perception that executives wield excessive influence over the process of determining pay, some consultants now advise that the compensation committee retain an independent consulting firm that has no other business relationships with the company.⁹ Eliminating the potential for a highly visible conflict within the overall governance process makes it less likely that decisions and programs will be questioned down the road.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Compensation Bonus & Severance Pay Business & Corporate Law Corporations Directors & Officers Compensation Salaries Business & Corporate Law Corporations Shareholders Actions Against Corporations Derivative Actions General Overview

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Cohen v. Ayers, 596 F.2d 733 (7th Cir. 1979)* .

(n2)Footnote 2. *See, e.g., In re Walt Disney Co. Derivative Litig., 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005)* .

(n3)Footnote 3. *See § 15.03[2][a][ii] below.*

(n4)Footnote 4. *See CEO Stock Option Overhang: Shareholder Boon or Shareholder Burden? A Study of Potential Dilution from Employee Stock Options and Its Relationship to Total Returns to Shareholders 1998-1999* (published by Watson Wyatt).

(n5)Footnote 5. RiskMetrics Group (RMG) considers dilution levels above the average for those companies with top quartile performance within an industry to be unreasonable. RMG's dilution calculation is based on what it refers to as a Shareholder Value Transfer ("SVT") formula. RMG uses a binomial option pricing model to determine the amount of shareholder equity flowing out from a company to its equity plan participants as options are exercised and restrictions on stock awards lapse. The total SVT cost of a company's equity compensation program is then measured against an "allowable" cost. The company-specific allowable cost or "cap" is determined by RMG based on a company's GICS (Global Industry Classification Standard) and is driven by several factors; among these, market capitalization and performance are important components. RMG also compares each company's annual share utilization rate or "burn rate", on a three-year average basis with the annual share utilization rate assigned each year for that company's industry

group (also based on GICS). RMG applies a multiplier to the number of full-value awards granted over each of the prior three years; the multiplier is based on the company's annual stock price volatility. If the burn rate three-year average exceeds one standard deviation more than the industry average for that particular GICS (and is greater than 2 percent), RMG will state in its proxy analysis report that the company failed the burn rate test. RMG would then recommend a vote against an equity compensation plan proposal to add shares that the company had on its meeting agenda, regardless of SVT cost.

(n6)Footnote 6. *See* RiskMetrics Group Governance Services US Corporate Governance Policy 2010 Updates at pages 23-28 (November 19, 2009).

(n7)Footnote 7. *See* PM&P Trends and Issues Report: Top 10 Executive Compensation Issues in the New Economy (April 2009).

(n8)Footnote 8. *See* PM&P Trends and Issues Report: Top 10 Executive Compensation Issues in the New Economy (April 2009).

(n9)Footnote 9. Pearl Meyer & Partners, the employer of the authors of this chapter, is an independent compensation consulting firm.



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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

2-15 Corporate Governance: Law and Practice § 15.03

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§ 15.03 Alignment with Shareholder Interests

[1] Shifting Views of "Alignment"

Many compensation committees and shareholder activists espouse the virtues of aligning executive compensation incentives with shareholders' economic interests. There is no consistent general consensus about what forms of incentive compensation programs achieve such alignment; perspectives on how best to align executive and shareholder interests through incentive compensation programs seem to vary from industry to industry and from epoch to epoch.

The popular view of what types of incentive compensation programs lead to alignment or misalignment of executive incentives and shareholders' economic interests changes over time. In the immediate post-Enron era, media stories blaming market volatility and executive myopia on the overuse of stock options and praising the virtues of restricted stock grants reflected a 180-degree reversal from the prevailing view of previous years, when restricted stock with time-based vesting was commonly criticized as payment for mediocrity. Within a single company, an incentive plan that worked well a few years ago may no longer be effective due to changes in business strategy, corporate culture, management composition, competitive environment or even the fact that participants have grown too familiar with the plan to be sufficiently motivated by it.

Despite changes over time and differences in perspective about the incentive compensation programs that best align shareholders' and executives' financial interests, there is a single bottom-line measure of corporate performance for shareholders: total shareholder return ("TSR").¹ So why not use TSR as the performance measure in all incentive plans? Although a plan tied to TSR (for example, over a three-year cycle) can provide a strong link between executive pay and shareholders' economic interests, we submit that TSR, standing alone, is rarely a sufficient basis² for an incentive compensation plan for the following reasons:

- performance should be considered relative to an industry or market index, rather than solely on an absolute basis, to avoid unduly rewarding or penalizing executives for fluctuations in stock or financial performance unrelated to executive performance. Since "all ships rise with a rising tide," the compensation committee has a responsibility to evaluate TSR performance in the context of broader market and industry performance, particularly over the long run;

- TSR is not directional with respect to business strategy; it does not inform management as to what levers should be pulled to achieve the business strategy reviewed with and approved by the board of directors; strong TSR is simply the hoped for result, over the long run, of effective implementation of the company's business strategy;
- TSR is a global, company-wide measure. While the CEO certainly has responsibility for overall results, it is often more appropriate and effective for a business unit head to focus on creating shareholder value at the business unit level, where there is no public stock instrument and therefore, no publicly determined business unit TSR;
- the stock price on either end date of a TSR performance cycle (for example, three calendar years) could be strongly affected by unusual market forces. Thus, TSR measures are potentially sensitive to timing;
- under FAS 123R,ⁿ³ if TSR is used as a performance measure and the maximum condition is not satisfied, previously recognized compensation cost cannot be reversed or trued-up to match the actual performance outcome.

The key is to understand the company's business model and then find a balance between financial operating, and stock performance measures without having an overwhelming number of goals. Since the optimal risk/reward model shifts over a company's life cycle, the types of incentive vehicles a company offers should also shift over time.

[2] Linking Executive Pay to Performance

[a] Prevalent Incentive Compensation Vehicles

[i] *Annual Incentive Plans*

Annual incentive awards are based on performance over one year. They are typically paid in cash shortly after the end of the fiscal year,ⁿ⁴ but some companies pay a portion of the award in shares, restricted shares, deferred shares or deferred cash.ⁿ⁵ Annual incentives are usually not paid out in stock options. The mix of cash versus stock may be mandated by the company or at the election of the executive. Particularly if the mix is elective, the company may provide an extra incentive to executives electing restricted stock in lieu of cash, for example, a "kicker" of 15 to 20 percent of the restricted stock value. Most companies that offer non-qualified deferred compensation plans allow participants to elect deferral of annual incentive awards.

Relatively few companies provide quarterly or semi-annual incentives to top executives. Similarly, top corporate executives would not typically participate in a sales compensation plan, with the possible exception of the top sales executive. The rationale is that top executives are responsible for delivering overall company performance over a time horizon of at least one year. Although the terms "annual incentive" and "bonus" tend to be used interchangeably, annual incentive awards should be based on pre-determined performance goals that are communicated to the participant at or before the beginning of the year. The pre-determination of goals does not preclude discretionary evaluation of performance at the end of the year, but ensures that participants have an incentive to achieve pre-established goals. The proxy disclosure rules adopted by the SEC in 2006 emphasize the importance of distinguishing between incentive and non-incentive plans, and eliminate the distinction between annual and long-term incentives.

A bonus award is not tied to specific goals and could be discretionary, such as the traditional Christmas bonus. To draw a fine distinction, a profit sharing plan that provides executives with strong motivation to meet and exceed specific profit goals would be considered an annual incentive plan, but a company-wide profit sharing plan that automatically

provides a small award to all employees is closer to a bonus program.

Performance measures used in annual incentive plans are often financial, operating or business goals, such as sales growth, cash flow from operations, net income versus target, reduction in administrative costs, units sold net of returns, room occupancy rates, number of new subscribers, or customer satisfaction ratings. While strategic goals often take longer than one year to implement--for example, become first in market share--interim milestones can be used in an annual incentive plan. However, determining the amount of the awards may be an issue for strategic goals that are "all or nothing." While some companies use TSR in their annual incentive plans, one-year TSR can be extremely volatile and more reflective of general market factors than individual company performance.

[ii] Stock Options

From the early 1990s through the first few years of the new millennium, stock option grants grew in both prevalence and size. In 1992, stock options represented about 30 percent of the pay mix for the CEO of the top 200 public companies measured by revenues (the "PM&P Top 200").⁶ By 2002, stock options represented about 60 percent of the pay mix.⁷ Most of this growth came through reduced emphasis on base salary and annual incentives in the pay mix. By 2004, however, stock options only represented about 32 percent of the pay mix, largely due to loss of beneficial accounting treatment previously offered by APB 25.⁸ In 2008, stock option use continued to represent about 32 percent of the CEO pay mix.⁹

The pendulum continues to go back and forth between either annual incentives plus long-term cash incentives versus stock options. In addition to increasing shareholder dissatisfaction with high dilution levels, a number of other factors may push companies to reduce or eliminate their use of stock options:

- In a down stock market, such as the marketing following the 2008 financial crisis, executives may become more risk-averse and therefore more willing to trade the potential gains from stock options for downside protection provided through "full value" awards like restricted stock.
- In a volatile stock market, executives may also prefer incentives that are not affected by general market movements outside their control.
- With FAS 123R mandating that publicly traded and privately held companies recognize the "fair value" compensation cost for share-based payments in their financial statements, the bias toward stock options was removed and companies have reevaluated whether stock options are the most effective incentive vehicle when there is a "level playing field."
- If companies must record an expense when they grant stock options and yet executives perceive less value in option grants than the accounting treatment suggests, stock option grants will be inefficient incentives. In this regard, some executives may not intuitively understand the complex logic of option valuation models and therefore, if the Black-Scholes formula (for example) is used to value the expense of option grants on the company's financial statements, they may not feel that they are receiving the stated value.
- Since the adoption of new stock exchange listing requirements in 2003, companies have been required to obtain shareholder approval for equity-based compensation plans, with only a few narrow exceptions. This has made it more difficult for companies to have a sufficient number of shares authorized for stock option grants.
- The press and general public have become increasingly critical of companies with stock option plans that result in high levels of dilution and repricing of underwater options. News stories in the wake of

Enron, options backdating scandals and other notorious corporate governance debacles shortly after the turn of the millennium equated executive greed with the overuse and misuse of stock options. This public perception caused companies seeking to regain investor confidence to consider a shift away from stock options to other forms of compensation.

Companies that maintain their stock option programs in down economies consider customizing the terms of their option grants to minimize their potential expense and to provide a stronger link to executive performance. One way to do this is to grant options with terms shorter than the historical norm of ten years without an offsetting increase in the number of options granted. Since executives typically exercise their options well before expiration, the greater expense of a ten-year option may not be justified.

In addition, with longer vesting schedules, the expense of option grants may be spread out over a greater number of years. Companies may also add performance-based vesting criteria (with vesting tied to company-specific performance measures or to TSR relative to the industry or the overall market).¹⁰ Premium priced options designed to ensure a recovery in stock price to previous levels may make sense. Option profits may be subject to clawback if financials need to be restated¹¹ or if executives violate non-compete or other restrictive covenants.¹² Companies may seek to turn option holders into long-term investors by requiring executives who exercise options to hold the company stock they receive for a specified number of years.

Although disclosure and shareholder control over dilution have improved in the post-Enron era,¹³ the challenge for investors remains understanding the true value of stock option grants given the disparate presentation of information about stock options in annual reports and proxy statements, and the intuitive opaqueness of the logic of the complex Black-Scholes and binomial models for valuing options, particularly when many outstanding options are underwater. The valuation of stock options will become increasingly important as companies consider shifting value to other equity incentives or cash awards and attempt to duplicate the value previously provided by stock option grants.

In response to the option "backdating" scandals that broke in 2006, the SEC's new proxy disclosure rules require significantly greater disclosure regarding option grant practices. In addition, option values shown in the Summary Compensation Table currently must conform to FAS 123R values shown in the financial statements.¹⁴ However, the valuation of options will also be subject to heightened sensitivity following the SEC's disclosure rules changes that will require companies to report equity grants at full grant date value, rather than FAS 123R accounting values in the Summary Compensation Table.

The post-2008 financial crisis left its mark in the form of options so underwater as to be deemed useless by many executives. Moreover, as unexercisable options continue to be charged against earnings and inflate overhang, it becomes increasingly difficult for companies to garner investor support for new share requests. Following the financial crises of 2008, over 100 companies across industries submitted proposals to their shareholders or filed a tender offer for an option exchange. These programs were intended to restore some equity value to employees left holding underwater options in the wake of the economic downturn. While, for many companies, an option exchange seems a quick fix to the problem, companies should carefully consider whether an option exchange is the best and most effective approach for their own underwater option problem. Critical questions to ask include:¹⁵

- *Is the timing right?* If the company's share price drops after the exchange, the new options provided in the exchange could also end up underwater, leaving employees no better or even worse off, with little motivational or retentive impact.

- *Is there high turnover now, or potentially?* Many shareholders facing significant equity losses will question the fairness of allowing employees to recoup value by turning in underwater options. An option exchange should be considered only to address an imminent risk of significant turnover and lost motivation in the absence of drastic action, and after other alternatives have been explored.

- *Does the exchange address investor concerns?* Investor approval is more likely if the proposed exchange includes "shareholder friendly" features, such as excluding executives and board members from the program and prohibiting any surplus shares from being added to the plan for future grants.

- *Is it worth it?* Option exchanges entail significant time and administrative effort, from the preparation of employee communications and proxy proposal to the tender offer and CD&A proxy disclosure. Substantial expense also may be incurred by grants of new options, restricted stock, or cash awards, as well as additional fees for accounting, legal, valuation and compensation experts.

If the administrative burdens, costs, and potential negative shareholder reaction to an option exchange outweigh the advantages, alternative approaches could include:

- *Migrating to an annual award schedule, rather than limiting awards to new hires, promotions and "special events."* If option grants have been less frequent, annual grants essentially reload employees each year with at-the-money options, triggering a fresh vesting schedule that promotes retention.

- *Making a supplemental grant of new at-the-money options, with appreciation capped at the exercise price of the underwater options.* Like annual equity awards, this approach creates a motivational and retention "bridge" between the current share price and the exercise price of the underwater options.

- *Using more restricted stock or performance-based restricted stock grants, in lieu of options.* Because they are immediately in-the-money, full-value shares can be an effective way to boost morale and retention.

- *Offering a choice of equity vehicles, such as a menu of stock options, restricted stock, or performance based restricted stock.* Tradeoffs could be made in terms of the different equity value provided by each instrument.

- *Increasing target cash incentive opportunities and reducing or eliminating equity awards for nonexecutive populations.* Nevertheless, employee stock purchase programs may be a better approach if the goal is to foster employee ownership.

- *Accelerating "deep" underwater options.* Under FAS 123(R), accelerating the vesting of a deep out-of-the-money award is not a substantive modification and any unrecognized compensation cost associated with the award can be recognized over the remaining original vesting period. While such a strategy does not eliminate the underwater option problem, it may be viewed positively by employees and restore some of the retentive capability of the awards. Because FAS 123(R) does not provide guidance on determining when an award is deep out-of-the-money, we strongly recommend that companies consult their accounting advisers on this issue.

- *Accelerating or forfeiting underwater options in order to accelerate the expense.* A company may prefer to take actions that would accelerate the expense for "old" underwater options into the current accounting period, rather than continue to carry the higher expense forward. Again, consultation with accounting advisers is recommended.

[iii] Restricted Stock

Restricted shares are equity securities with restrictions on sale and transfer that lapse either over time assuming the executive continues to be employed by the company (so-called time-based vesting) or as a result of the achievement of

predetermined performance criteria (so-called performance-based vesting). Dividends on restricted shares may be paid to the executive as they are declared,ⁿ¹⁶ or they may be accrued until the vesting restrictions have lapsed. Unvested restricted shares are forfeited if the executive terminates employment prior to the vesting date, although some plans provide for pro rata or accelerated vesting in the event of death, disability, retirement or dismissal without Cause. A typical vesting schedule for restricted stock would be 100 percent vesting at the end of three years ("cliff vesting") or vesting of one-third of the restricted shares granted on each of the first three anniversaries of the grant ("step vesting"). The vesting schedule could be longer, particularly for large awards.

Unlike in the case of stock options, executives do not have to pay any exercise price to receive restricted shares. Thus, restricted shares are considered "full value" awards. Restricted shares are a strong retention device, since they have value even if the stock price declines. Restricted shares may be granted to executives to balance the "upside only" nature of stock options and to ensure retention of key executives while providing a link between executive rewards and share price appreciation.

Restricted stock typically bears an accounting charge equal to the value of the shares on the date of grant, spread over the vesting period. Due to the accounting expense, restricted share grants had historically been limited to senior executives. Since vesting of restricted stock has most often been based on continued service without regard to performance (unless an executive's employment is terminated for poor performance), critics have charged that restricted stock grants amount to pay for mediocrity. When it became clear, after the turn of the millennium, that the accounting rules would be changed to require expensing of stock options, companies began to consider broader use of restricted stock.ⁿ¹⁷ Restricted stock is an efficient incentive vehicle in that the value perceived by employees is typically close to the accounting expense. The perceived value falls below the accounting expense only if the stock price declines following the grant.

Career shares or deferred shares are special grants of restricted shares with a considerably longer vesting schedule, such as vesting upon retirement.ⁿ¹⁸ Career shares can also be designed as a purchase of restricted shares at book value, with the ability to convert into common shares at the market-to-book multiple upon acquisition of the company. Deferred shares are a common component of directors' compensation programs and, following the fiscal crisis of 2008, have been viewed by regulatory agencies and the media as the panacea in executive pay for preventing short-term risky behavior at the expense of long-term company success.

Performance-accelerated restricted stock ("PARS") vests on the basis of time, but vesting may be accelerated if certain performance goals are met. For example, a restricted stock grant vests 100 percent at the end of six years, but vesting will accelerate to the end of the third year if net income growth for the three-year period exceeds pre-established targets.

Performance-contingent restricted shares vest only if certain performance goals are met. There may also be a time-based vesting restriction. For example, vesting occurs when the market price of the company's stock has increased by 100 percent, but in no event earlier than three years from the date of grant. Historically, relatively few companies granted performance-contingent restricted shares because they were subject to variable accounting under APB 25. However, there has been an increase in the prevalence of performance-contingent restricted stock grants since the adoption of FAS 123R.ⁿ¹⁹

[iv] Long-Term Incentive Plans

Long-term incentive plans ("LTIPs") are similar to annual incentive plans, except that performance is measured over a multi-year period, typically three or four years. LTIP awards are granted before or early in the performance cycle and, to the extent that pre-established performance targets are met, they result in payments at or shortly after the end of the performance cycle in cash, shares or a mix of cash and shares. A new performance cycle may begin before the first cycle has ended (an overlapping cycle) or not until the end of the previous cycle (a non-overlapping cycle).

When a new performance cycle begins every year, payouts are made annually (assuming performance goals are met) after the initial ramp-up period. To avoid a ramp-up period, some companies implementing a new LTIP will simultaneously start "stub period" cycles. For example, a new LTIP has three-year performance cycles based on cumulative net income starting every year but, when the plan is first introduced, one-year and two-year stub period cycles are started at the same time as the first three-year cycle so that participants do not have to wait three years for the initial payout. As with annual incentives, compensation expense is accrued over the performance period (and possibly over a vesting period following the end of the performance cycle). The total expense for a cash LTIP equals the actual payout/value earned at the end of the performance cycle. Unlike stock options or restricted stock, the total expense for an LTIP cannot be fixed at the date of grant (at the start of the performance cycle).

LTIPs can be designed in many forms, including long-term cash incentive awards, performance units, performance shares, phantom shares, or dividend equivalents. LTIPs are often designed with target, maximum and threshold award levels for specific performance achievement levels. The upside opportunity need not mirror the upside in the company's annual incentive plan. The maximum LTIP award level is typically 150 percent of the target award, although some LTIPs provide for maximum payout of up to 200 percent of target (or more). There may be less upside in the LTIP than in the annual incentive plan, particularly if the business strategy is to deliver consistent long-term results. In contrast, if an LTIP is designed to mimic a stock vehicle, the upside value per phantom share can be unlimited, just like a real stock award.

Long-term cash incentives linked to long-term financial performance may be used to balance stock options or restricted stock. Financial measures included in such LTIPs are usually "bottom line" or profitability measures. However, total shareholder return relative to a peer group is also a common measure used to provide a link to stock performance in a cash LTIP.²⁰

Performance units often have a fixed dollar value per unit and the number of units earned varies according to performance. When the unit value is \$1, the performance unit plan design is equivalent to a cash LTIP. Alternatively, the dollar value per unit may vary based on performance, for example, the unit value equals earnings per share, but the number of units is fixed. Allowing both the unit value and the number of performance units earned to vary is possible, but atypical due to the additional and unnecessary complexity it introduces.

Performance shares are conditional grants of nominal shares earned on the basis of performance. They are nearly identical to performance-contingent restricted shares and to performance units where the unit value equals the underlying stock price. Dividend equivalents on performance shares are typically accrued until the end of the performance or vesting period.

Phantom shares are similar to performance units, where the unit value is linked to the value of a private company, subsidiary or business unit. Phantom share plans may be designed to mimic stock options, stock appreciation rights²¹ or restricted stock, but they are typically paid in cash since the underlying stock is not traded publicly and the company does not want minority shareholders. Unlike stock options in a public company, phantom shares are less likely to be granted annually, and participation in a phantom share plan is often limited to senior executives.

The most critical design feature of a phantom share plan for a private company (including a subsidiary of a public company) is often the valuation methodology for the shares. The value of phantom shares is usually based on a pre-set formula or determined by an independent third party. Examples of valuation formulas include multiple of subsidiary cash flow (based either on market multiples at the time of settlement or fixed at the start of the plan), multiple of earnings per phantom share and book value per phantom share. Since an independent third party valuation can be costly and the result may be a range of values that is not sufficiently narrow for a compensation plan, some companies rely on the internal finance area to provide a valuation model, such as a discounted cash flow analysis. If an internal valuation model is used, key inputs (or the specific methodology for determining them) must be agreed upon in advance, since valuation models are often quite sensitive to the underlying assumptions.

When designing a phantom equity plan for a subsidiary or business unit, it is necessary to determine whether any executives outside the unit will participate. For example, some regulated utilities developed phantom share plans for executives in their non-regulated business units of the holding company. Given the regulated environment, the CEO and other top officers of the regulated utility parent company often do not participate in the phantom share plan. From a corporate governance perspective, the CEO should be responsible for the financial performance of the entire enterprise, not simply one subsidiary. In addition, if finance officers are determining the value, they should not be participants in the plan.

Dividend equivalents are similar to performance units where the unit value equals the accumulated dividends on a specified number of shares. Payouts are typically made in cash. Dividend equivalents associated with restricted shares are usually subject to time-based vesting, if there is any vesting requirement at all.²² Performance-based dividend equivalents are attractive for companies with high dividend yield stocks, although RMG considers payment of dividends or dividend equivalents on unearned performance awards to be a problematic pay practice. Historically, regulated utilities adopted dividend equivalent plans instead of (or in support of) stock options.

[v] *Other Hybrid/Designer Incentive Vehicles*

Compensation professionals have developed variations on the "plain vanilla" annual and long-term incentive vehicles. Hybrid plans and designer incentive vehicles are not common, possibly because they tend to be more complex or because some of the designs resulted in variable accounting under old APB 25 treatment. However, many of these concepts were developed to provide a stronger link to performance or introduce a retention "hook". Adoption of FAS 123R eliminates the accounting bias in favor of the plain vanilla stock option, allowing greater flexibility to offer designer incentives like indexed stock options.

Hybrid incentive plans may be difficult to classify because they often have features of both annual and long-term incentives. Examples include plans that measure annual performance but pay out in a mix of cash and restricted stock; the bonus "banking" design;²³ plans that provide annual cash payouts with an extra "kicker" if annual performance targets are met in consecutive years, or long-term plans that specify a number of shares to be earned over a multi-year period, with earned shares being released to participants annually based on cumulative performance. If annual incentives cover a one-year time horizon and stock options are intended to motivate executives over a ten-year option term, hybrid plans fill the need for incentives tied to intermediate-term performance.

Although designer incentive vehicles are not prevalent overall, some of the more common types have been reviewed in prior sections. The nomenclature for designer incentive vehicles is not universal, but a partial listing is provided below.

- "Designer" stock options:

- Premium and premium step-up: exercise price is above fair market value.
- Discount: exercise price is below fair market value. Note, however, that such options will now be treated as deferred compensation and subject to the requirements set forth in *IRC Section 409A*.
- Escalating: exercise price increases on a pre-set basis, for example, cost of capital or interest rate.
- Index: exercise price is indexed to a peer group or market index.
- Reload: re-grant of options upon exercise. Reload option carries same remaining term

as underlying option and shares received upon exercise are sometimes subject to retention requirements. Appeal for this type of award has been diminished, however, with the adoption of FAS 123R, as each reload grant must now be accounted for as a separate award resulting in incremental compensation cost for each reload grant.

- Truncated: option term is truncated upon reaching pre-set stock price target.
- Performance-contingent: exercisability is triggered by reaching a stock price target or performance goal. Under FAS 123R, however, if the contingency is related to stock price or total shareholder return, previously recognized compensation cost cannot be reversed if the award is subsequently forfeited or reduced because the market condition had not been met.
- PARSOP: performance-accelerated stock option where exercisability is accelerated by reaching a performance goal.
- Phantom: option exercise price and value at exercise based on value of non-public company, subsidiary or business unit.
- Parallel: performance unit granted in parallel to fund option exercise cost and taxes.
- Exchange: options granted in exchange for other compensation that is forgone.
- Investment: specified multiple granted to match an executive's "at risk" purchase of company stock, such as three options granted for each share purchased.
- Deposit: option grant made in exchange for executive's deposit of owned shares.
- Equity: option carries short term. Executive exercises immediately and makes *IRC Section 83(b)* election.ⁿ²⁴
- Career: option is exercisable until retirement or termination and carries lengthy vesting restrictions.
- Horizon: option is exercisable for an extended period post-retirement.

■ "Designer" stock grants:

- Share retention premium: additional shares granted for holding shares beyond vesting or option exercise.
- Deferral premium: additional shares granted for elective or mandatory deferral of cash into restricted or deferred stock.
- Investment: restricted shares granted to match an executive's "at risk" purchase of company stock.
- Phantom: restricted stock-like instrument linked to value of non-public company, subsidiary or business unit.

[b] Choosing the Right Performance Measures

[i] *General Considerations*

The compensation committee²⁵ is responsible for the company's pay-for-performance relationship. While most compensation committees are watchful of high pay levels, pay levels are only one side of the equation. Choosing the right performance measures ensures that the other side of the equation was not rigged to deliver an unsound pay-for-performance relationship.

Performance measures selected for use in incentive plans should be linked to the business plan and financial goals of the company; easy for the participant to understand; related to something that the participant can reasonably influence; neither duplicative nor in conflict with other performance measures (in the same incentive plan or in other incentive plans used by the company); and measurable and able to be tracked over time. In the wake of the fiscal crisis of 2008, there is new emphasis on avoiding performance measures that incentivize unduly risky behavior. They should also be tied to a longer-term horizon, rather than encouraging only short-term gains.

Some common problems in the choice of performance measures are:

- too many goals, so there is little incentive tied to each goal and the participant is not motivated to achieve any one goal;
- too few goals, so there is too much incentive tied to a single goal and the participant is motivated to engage in risky behavior or paid twice for the same achievement (for example, when both annual and long-term incentives are linked with a single measure);
- too little "stretch" in the goals, resulting in awards being paid for ordinary or mediocre performance;
- too much "stretch" in the goal, discouraging participants from even trying to reach the target performance level;
- conflicting goals that pull in different directions (such as revenue growth and return on equity; acquisitions, for example, usually add revenues, but may lower near-term return on equity);
- overly complex performance measures so that, without extensive education and communication, participants may not understand how to improve performance and therefore, make no changes in behavior as a result of the "incentive" plan;
- performance measures that are too global and not related to aspects of performance reasonably within the participant's control;
- too little emphasis on global measures, resulting in unhelpful competitive behavior, rather than teamwork, among executives;
- performance measures that are too readily manipulated by adjustments for unusual or unexpected events, especially if an accounting adjustment has a large impact on incentive award payout and the decision to make the adjustment is largely subjective;
- misalignment with the business plan or economic cycle resulting from the use of the wrong measure, such as a measure linked to revenue growth when the company's priority is to cut costs;²⁶ and

- use of the performance measure for too long, so that (a) participants are inured to the plan and no longer sharply focused on the behaviors required to reach target results, (b) participants have figured out how to "game" the results (almost always a problem when targets are actual expenses or revenues as a percentage of plan, for example), or (c) the company has changed its business strategy without readjusting performance measures to promote behaviors that will support the new strategy.

In selecting performance measures, it is helpful to consider whether a particular measure is used by a number of peer companies within the industry, by a key competitor or by institutional investors and stock analysts. If so, the measure is more likely to relate to expected or relevant aspects of company performance. However, the compensation committee should consider whether other alternatives might be more suitable, since making the same choices as the rest of the industry is unlikely to result in superior performance. Conversely, if the selected measure is outside industry norms, the compensation committee should at least understand that it is atypical and the rationale for differentiation, such as a unique business strategy.

While there is no one right choice, it is possible to test whether a particular measure has shown strong or weak correlation with total shareholder returns, assuming a sufficient number of data points to make a statistically significant comparison. Compensation committees may find it helpful to examine a variety of performance measures over a series of three, five and ten year periods and see which have had a higher correlation with TSR over that period. This analysis can be performed for the company and for a group of comparator companies in the same industry. This industry analysis is also helpful in selecting a comparator group when performance is to be measured on a relative basis. There may be short-term timing differences as the market evaluates the success of a company's business strategy, but over the long run there should be a relationship between the performance measures used for incentive compensation purposes and shareholder value creation. But even a strong correlation between EPS growth, for example, and TSR may not necessarily answer the question of whether EPS growth caused an increase in stock price, or whether other market forces or economic conditions had a greater impact. Compensation committees should resist the temptation to throw up their hands and default to TSR as the annual incentive measure. It is unlikely that TSR, at least over the short term, accurately or fairly measures the performance of senior management in implementing the company's business strategy.ⁿ²⁷

[ii] *Stock, Financial, Operating or Strategic Performance Measures*

In deciding whether to use stock, financial, operating or strategic measures in annual and long-term incentive plans, the compensation committee should take note of some practical considerations:

- Financial performance measures are often the basis of annual incentive plans, but many companies prefer to rely on stock performance in their long-term incentives. This provides a balance between financial and stock performance.
- Revenue growth may be used in annual incentive plans but is less prevalent in long-term incentive plans. The company is in business to make a profit over the long term; revenue growth alone is typically not sufficient to ensure shareholder value creation.
- Total shareholder return is usually not included as an annual performance measure since it can be highly volatile from year to year and in any event now carries adverse accounting implications for equity based compensation under FAS 123R should the award subsequently be forfeited.
- Long-term incentives are predominantly equity-based so that there is a strong link to shareholders' economic interests over the long run.

- Vesting of equity-based incentives may be linked to achievement of stock price levels,

top quartile stock returns or specified levels of financial performance. Like the TSR measure, however, market conditions related to achievement of stock price may result in adverse accounting implications under FAS 123R should the award subsequently be forfeited or reduced.

- Some companies offer a long-term cash performance plan in addition to equity-based incentives. In this case, using a stock performance measure in the cash plan could be duplicative or place too much emphasis on global measures.

- Operating measures may be at the corporate, departmental or business unit level. However, operating measures are usually not the only measure for the most senior executives, who are ultimately responsible for the company's financial and stock performance. Operating measures can be particularly effective when department or business unit managers do not control the overall economic performance of the parent company. Executives in a start-up situation may also be linked to operating measures, such as developing and bringing a product to market on schedule, rather than earnings growth. In certain regulated industries, like electric utilities, operating measures related to power outages or safety may be used in addition to financial and stock performance measures to highlight the importance of the customers and employees as stakeholders.

- Strategic measures are often reserved for senior executives who set business strategy or are charged with carrying out the business plan. Strategic goals may include achievement of business "milestones" within a specified timeframe. One drawback of this approach is that the relationship between the amount of the award and the value of the achievement may be subjective, or the award may be "all or nothing." Examples of strategic measures include:

- find local country financial partner for joint venture expansion in Asia;
- gain regulatory approval for a particular acquisition within nine months of signing a letter of intent; and
- take company public by a specified date.

[iii] Corporate, Business Unit or Individual Performance Measures

Companies often use a mix of corporate, business unit and/or individual measures. CEO annual incentives are typically linked to overall corporate measures, since CEOs have ultimate responsibility for short- and long-term corporate results. Linking CEO annual incentives to business unit or product line measures is unusual, but has been done. For example: (a) the CEO of an asset management firm who is also the lead manager for a specific fund and receives an award component based on that fund's performance; or (b) the CEO of a holding company who receives an annual incentive award that is the weighted average of the business unit awards.

CEOs may also be rewarded for achievement of individual goals, but to the extent performance evaluation is subjective and not verifiable by a third party, the measure could not be used as the basis for qualifying compensation as performance-based under *IRC Section 162(m)*.ⁿ²⁸ Annual incentives for business unit executives are often linked to business unit performance, but they may also have an award component that is based on overall corporate performance to promote teamwork. A typical mix would be 25 percent weight on corporate performance and 75 percent weight on business unit performance (or 50/50 for a business unit head who also is a member of the corporate executive council). Some companies tie annual incentives for top business unit executives entirely to business unit performance but, in that case, long-term incentives should be heavily weighted toward corporate results (financial or stock performance).

While the importance and prevalence of business unit and individual goals are greater for non-executive positions, which are not the compensation committee's focus, the committee should still have confidence that the executive compensation program they have approved is not misaligned with the rest of the company's compensation programs and performance objectives.

[iv] *Absolute Versus Relative Performance Measures*

Absolute performance measures are those that compare actual results with a fixed, absolute standard, such as actual EPS versus target EPS. Relative measures are those that compare company performance with that of the market or the industry, such as company TSR versus the TSR of the S&P 500 companies or versus TSR for a group of industry peer companies.ⁿ²⁹ While absolute and relative measures can be found in annual or long-term incentive plans, relative measures, especially relative TSR measures, are more common in long-term incentive plans. Each company is focused on its own "absolute" performance in the short term, but must compete with peer companies in the long term to attract capital and executive talent. Advantages and disadvantages of absolute and relative measures are discussed below.

Absolute measures have several advantages. First, participants know at the beginning of the performance period exactly what performance level is required to achieve a target award; the target performance level does not change over time. Second, with absolute measures, there is no need to select peer companies and monitor their performance. This may be particularly difficult if a company's key competitors are privately held or have a business mix that makes it difficult or impossible to find the most pertinent detailed performance data in their segment reporting, or if the company has a unique business mix. Third, absolute measures have appeal to the participants because they can directly affect their own company's results and are not impacted by the results of other companies over which they have no control.

Absolute measures also have some distinct disadvantages. First, absolute goals may turn out to have been too easy or too hard, since results for the industry or market as a whole may be buoyed or depressed by extraneous factors over which the executive has no control or influence. Second, with absolute goals, the longer the performance period, the more difficult it is to predict the appropriate degree of "stretch" required for target payouts. Since absolute goals do not change over the performance period, they cannot reflect changes in market conditions. As such, an absolute goal may become obsolete or unduly difficult to achieve, especially over a longer (for example, three-year) performance period. Participants may be discouraged if it becomes apparent early in the performance period that the absolute goal is unattainable. Conversely, participants may receive windfall awards if the absolute goal turns out to be too easy to achieve because, for example, market forces benefit the entire industry.ⁿ³⁰ Finally, absolute financial goals may turn out to be poorly linked to or "out of synch" with stock performance. From a corporate governance perspective, an undesirable outcome would be superior performance versus an absolute goal that yields maximum awards, but poor relative TSR performance (disclosed in the same proxy statement).

Relative measures also have advantages and disadvantages. The major advantage of a relative measure is the assurance that superior rewards will be paid only when the company's performance beats the market or a peer group. It is, of course, relative performance that makes an investment in a company attractive or unattractive (since the investor has the whole market to choose from). In addition, using relative measures avoids windfall payouts or undeserved penalties as a result of exogenous factors over which executives have no influence or control. Relative measures avoid the need to predict the absolute level of performance required for target payouts. They also eliminate the effect of changes in market conditions so participants can earn awards for exceeding peer group or market performance even when the entire industry or the entire stock market is down.

One major disadvantage of using relative measures is the fact that the performance level needed to "win" is not known until the end of the performance period. While it is typical for companies to provide participants with interim calculations of relative performance, the calculation may be complex and unreliable, and participants may not be able to track performance against the ultimate goal on a daily or monthly basis. This aspect gives the use of relative measures something of the character of a horse race, where the winner is not known until the end and a late surge in performance

by a competitor could change the relative outcome of the company's performance over the measurement period. Also, it is possible to be the winner in the horse race but still not produce any absolute value for shareholders. In a down economy, investors are wary of outsized rewards for "best of the worst" performance.

In addition, with relative measures, selection of a sufficient number of peer companies may be difficult if competitors are private or conglomerates (with insufficient detail in segment reporting to be useful for benchmark purposes) or if a company has a unique business mix. In general, it is preferable to consider a peer group of at least eight to ten companies of similar size. Still, many executives perceive their peer groups as imperfect, if not seriously flawed, due to unique business factors. Other peer group issues include:

- Industry consolidation may result in the loss of one or more peer companies during the performance period.
- Peer company results may be skewed by extraordinary revenues or expenses (including, for example, those arising from acquisitions, divestitures or judgments or settlements from litigation), the identification and effect of which are difficult to isolate from publicly available information.
- Peer companies with exceptional (for example, 75th percentile) relative performance may include "recovering dogs" that have the advantage of starting from a low base.
- Since counter-cyclical diversification smoothes business performance, a company with more diversified businesses than its peers is less likely to achieve superior results relative to less-diversified competitors, but very few peer group comparisons are sufficiently sophisticated to look at results on a risk-adjusted basis (by factoring in standard deviation of returns).
- Timing may be an issue, particularly with relative financial performance, if peer company results are not available when the company wishes to pay its annual or long-term incentive awards.
- Awards are directly impacted by market factors or results at other companies that participants cannot control. However, it may well be appropriate for senior executives to be held accountable for anticipating and responding quickly to shifts in market and competitive pressures.

[v] Pay Programs in a Down Economy

Challenging economies, such as the post-2007 U.S. economy, put pressure on expense control and cash management, even as companies must incentivize high performers and minimize retention risks. Compensation committees are expected to reflect poor/reduced performance in their compensation determinations, and institutional investors take a skeptical view of retention risk as the rationale for pay decisions in an economy that has experienced significant job losses and limited new hiring.

A good initial approach to executive salaries is to focus on more moderate increases, targeted to managers whose current pay is below-market. If the economy worsens, salary freezes are the next course of action, with salary cuts or furloughs reserved for extreme circumstances.

For annual and long-term incentive programs that are generally working well, tweaks in down economies may include:

- *Widening the gap between threshold and maximum performance.* Goal-setting is more difficult when business results are less predictable. A greater differential can help ensure the company does not underpay executives when the economy takes a turn for the worse or overpay when it recovers.

- *Targeting a performance range, rather than one specific level.* When business results are less predictable, a range of acceptable performance may be more relevant than a precise target. Similarly, exact interpolation of performance results and payouts could be replaced with performance ranges or "buckets" that would result in threshold, target or maximum payouts.

- *Changing incentive plan metrics.* Wholesale changes should be considered only if business and economic conditions fundamentally change, given the importance of the interaction of annual and long-term incentive plan metrics. For example, cash management can be adopted as a metric if such an approach would help satisfy bank covenants.

- *Providing more long-term incentives in time-vested restricted shares.* If sufficient option shares cannot be granted to match the previous year's long-term incentive value, restricted shares can help bridge the gap. They are generally perceived as more valuable and provide more of a retention hook.

Top-performing executives and those considered high retention risks may need special attention in a down market. Although it is generally not good practice to institute *ad hoc* or additional salary increases, these program tweaks may be appropriate:

- *Set aside money (for example, 20 percent of the target pool) for awards to high performers and retention risks.* This might be necessary even if threshold performance levels are not met under the annual incentive plan.

- *Grant additional shares to higher performers and retention risks following a poor performance year.* Even a thoughtful and well-designed plan to communicate the payout results may not satisfy executives who receive a reduced or zero incentive award. Coupling additional long-term equity grants with zero annual incentive awards may soften the blow, but institutional investors may object if the pay-for-performance relationship becomes misaligned as a result.

[vi] *Selecting Measures and Setting Goals in a Down Economy*

In troubled economies, some general trends typically emerge with respect to selecting performance measures:ⁿ³²

- *More robust analysis of "value drivers."* Company-specific, peer-group and industry analyses can help identify specific measures of performance that correlate most closely with creating meaningful, long-term shareholder value.

- *More focus on cash flow measures.* As companies enter "survival mode," targets related to working capital management, debt coverage, and operating cash flow replace traditional profitability and return measures.

- *More consideration of non-financial or non-GAAP customized measures.* When financial results are expected to be poor, but not so much that the company is in "survival mode," companies tend to incorporate non-financial, operating or strategic measures, as well as individual performance goals. To the extent that financial measures are included, companies may move beyond pure GAAP definitions to adjust for factors that are beyond management's control, at least in the short term. These "adjusted" definitions often exclude non-operating or non-recurring items that are not necessarily appropriate variables for determining incentive awards, for example, restructuring charges, asset impairments and losses from discontinued operations. Making these adjustments at the *beginning* of the performance period ensures objectivity and limits the need for subjective changes at the *end* of the performance

period.

- *More consideration of purely "discretionary" short-term incentive plans.* Formula-based programs face the challenges of poor visibility, and companies using such measures face continued SEC pressure to disclose forward-looking performance goals. While taking a totally discretionary approach to executive incentives might work for some companies, it is generally not a broadly viable strategy, given the push for greater transparency and the potentially greater pressure on the compensation committee to apply its discretion for each award.

Recommendations for setting performance goals in poor economies generally include:

- *Consider shareholder expectations of forecasted growth in evaluating short-term and long-term business plans and goals.* This is especially important because share prices often move in response to how performance compares with expectations. This perspective is especially important for long-term incentive plans, which are intended to reward only sustainable increases in shareholder value.

- *Incorporate a relative measurement framework.* With limited visibility into future outcomes, some incentive programs use an appropriate peer group or index for comparison purposes. However, key stakeholders may not view being "best of the worst" as an appropriate performance target.

- *Establish "enduring standards" as opposed to annual budgets.* Maintaining performance standards year-over-year can address concerns about the annual budgeting process and separate incentive targets from annual budget expectations. An example would be a fixed targeted earnings growth rate, or return on capital, that represents an enduring standard for shareholder value creation in the industry. This approach eliminates any incentive to "sand bag" the budget, but may render performance expectations unrealistic over time. The best approach in a rapidly changing global economy may be a hybrid: an "enduring standard" that is reviewed every few years.

- *Set "self-adjusting" multi-year targets.* When long-term goal-setting is difficult, companies can choose to automatically adjust performance targets annually. The objective is a multi-year measurement period, in which each year's results affect future year requirements so that pre-determined goals do not go stale. For example, actual versus target performance in Year 1 would automatically adjust the initial Year 2 target up or down accordingly. so that, if the company achieved 105 percent of the Year 1 goal, for instance, the Year 2 goal would automatically increase by 5 percent. Alternatively, a constant growth rate could be applied to each year's actual performance result.

Because measure selection, measure definition and goal-setting are the building blocks of the risk/reward profile of the executive compensation program, the end of the planning process should include an overall risk assessment. The senior risk officers and the audit committee may also need to be involved to help ensure that measures and goals are not construed as promoting "excessive risk-taking" by executives.

Overall, in a down economy, the emphasis is on selecting measures and setting goals that motivate incentive plan participants to make the difficult choices that are needed to ensure sustained, long-term shareholder value, while controlling the tendency to distort the incentive plan goal-setting process for retention purposes.

[3] Compensation Risk: The New Risk Assessment Process and Plan Design Considerations

The near collapse of the financial markets and the ensuing global economic downturn have caused politicians, the media and individual citizens to point an accusatory finger at excessive risk-taking and the outsized compensation programs that fueled Wall Street. While many policy-makers have embraced proposals intended to control risk in compensation

programs, as of the date of this writing no authority has specifically defined "risk" or provided a construct for how to evaluate it.

The SEC's proposed rule changes require disclosure about "how the company's overall compensation policies for employees create incentives that can affect the company's risk and management of that risk." analysis required would not be confined to the named executive officers whose compensation is disclosed in Summary Compensation Table of the proxy statement if risks arising from compensation plans and policies for employees "may have a material effect on the company." The proposed rule changes would also require discussion of the board's "involvement in the risk management process," in order to provide "important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company."

TARP recipients are required to evaluate and address compensation risks, including certification by the compensation committee. While this is not currently required for non-TARP companies, all public companies, their board members and their advisors should develop an early understanding of whether and how the companies' compensation plans may be encourage or mitigate excessive risk-taking.

[a] Oversight and Responsibility

There is no clear authority that points to who is responsible for managing business risks, including risks arising from compensation plans. The risk-monitoring and management process typically involves management, the board, the audit committee and, to a lesser degree, the compensation committee. Often, the senior risk officer (or another executive responsible for risk management) makes a presentation about general business risks to the board or the audit committee at least annually. Separate board risk committees are still a rarity among public companies--only 3 percent of Top 200n33 companies have separate risk committees, and the prevalence decreases in the smaller company size categories.

The compensation committee typically considers and approves compensation plan designs and payouts for executives. Most compensation committees regularly consider design elements such as the degree to which executive pay is "at risk" or performance-based, selection of performance measures, the mix of short- versus long-term incentives, and stock ownership guidelines. While inappropriate choices may result in a compensation plan that encourages excessive risk-taking, most compensation committees have not directly engaged in a formal, comprehensive compensation risk assessment.

[b] Conducting a Risk Assessment³⁴

Details of a compensation risk assessment vary by company, but the overall nature and scope of the assessment are likely to become more consistent across companies as disclosure becomes mandatory. The main components of a compensation risk assessment may be grouped into four broad categories:

I. Compensation Program Design

II. Per- for man ce Met- rics & Goa l Set- ting

- Comparison with external market peers

Degree of "stretch" tested versus external market

- Protections: clawbacks, bonus deferral, caps, etc.

- Funding mechanisms ensure payouts are affordable

III. Administrative Procedures

IV. Communication & Disclosure

- Approval of goals at start of performance cycle

- Communication materials are clear and timely

- Established definition for each metric

- Incentive goals support com

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The compensation risk assessment should consider overall compensation risk, as well as risk stemming from specific incentive plan features. Examples of design features that could encourage inappropriate risk-taking include:

- Pay philosophy that targets market 75th percentile pay for 75th percentile performance along with a steep downside
- Heavy emphasis on short-term, cash incentives
- Large variations in pay for small variations in performance
- Lopsided payout opportunity, *e.g.*, uncapped upside and low threshold performance goal
- Over-reliance on a single performance measure
- "All or nothing" incentive award for exceptional performance
- Reliance on fixed/guaranteed pay, such that executives bear no cost or penalty for taking excessive risk

- Frequent application of "exceptions to the rule" to exclude factors beyond management's control

While any one of these features may be appropriate as part of a balanced compensation program, an accumulation of such features may signal trouble. The compensation risk assessment helps identify misalignments or weaknesses, but there are other warning signs. Unintended consequences like undesirable employee behavioral changes (sometimes a problem with sales incentives) or widely divergent employee satisfaction scores across business units could also be evidence of an imbalance in compensation risk.

It is also important to understand how compensation risk may be interrelated with non-compensation policies. For example, risk-taking may be controlled through the capital budgeting/investment process. Some business risks are rarely linked with compensation because they are unlikely or may be addressed with insurance. Conversely, a corporate culture that emphasizes "winning at all costs" could predispose executives toward riskier decisions.

The most appropriate level of compensation risk for a specific business strategy is not always obvious. Companies pursuing a high-risk business strategy may deliberately compound the business risk with a highly leveraged compensation program, for example, a start-up with heavy reliance on stock options. Mature companies with a moderate business strategy may increase compensation risk as multiple incentive plans are layered. Even when the compensation committee reviews a tally sheet that totals all pay elements for each executive, it may be difficult to evaluate the cumulative upside potential of complex incentive plans, especially equity-based plans.

Recently, more companies are applying an in-depth analytical tool called "dynamic pay modeling." This model allows evaluation of the pay-for-performance relationship over time by projecting future award payouts under the full range of performance scenarios.

Despite media attention on excessive compensation risk and the likelihood of enhanced disclosure, companies should not be dissuaded from adopting compensation programs that encourage appropriate risk-taking. Furthermore, a compensation program with insufficient upside may cause retention issues as executives seek more competitive opportunities for wealth creation. The key is to ensure that the level of rewards and the business risk-taking being rewarded are in the long-term interests of shareholders. In the end, a well-designed, balanced compensation program remains a highly effective means of driving corporate performance by encouraging innovation and appropriate levels of risk-taking.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersCompensationBonus & Severance PayBusiness & Corporate LawCorporationsDirectors & OfficersCompensationSalaries

FOOTNOTES:

(n1)Footnote 1. Total Shareholder Return ("TSR") = stock price appreciation plus reinvested dividends (same calculation as required for the proxy performance graph).

(n2)Footnote 2. We note that other observers have cautioned against using stock price as the sole performance measure in incentive compensation programs. *See, e.g.*, Business Roundtable, Executive Compensation: Principles and Commentary at 6 (Jan 2007) (reproduced in full as Appendix 15-A to this chapter); Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at 7 (2007) ("Performance objectives should be based on multiple factors--quantitative and qualitative--as opposed to stock price alone");

RiskMetrics Group's 2010 policy manual (November 19, 2009) (citing use of a single performance metric for short- and long-term plans as a practice that could contribute to excessive risk-taking).

(n3)Footnote 3. Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004), Share-Based Payment (Statement 123R) repealed the "intrinsic value" method of accounting for equity compensation prescribed by APB Opinion 25 and replaced the original Statement 123 with a mandate that generally all equity awards granted to employees be accounted for at "fair value". FAS 123R generally became effective for public companies for fiscal years commencing after June 15, 2005, and for private companies for fiscal years commencing after December 15, 2005.

(n4)Footnote 4. Annual incentive awards must be paid within 75 days following the end of the fiscal year to be deductible for the fiscal year in which they were earned. *See* Prop. Treas. Reg. § 1.404(b)-1T, Q&A: A-2(c). In addition, compensation must likewise be paid within such a time period if the company desires to have the payment fall within the "short-term deferral" exception under Section 409A. Companies generally accrue expense during the year at the target award level (if there is a target) but are required to change the accrual rate if it becomes likely that actual payouts will be much below or above target. By the end of the year, the total annual accrual should equal the actual payout to be made. In the proxy statement summary compensation table, annual incentive awards are reported in the year in which they are earned, not the year that they are paid out.

(n5)Footnote 5. To the extent deferred awards are subject to performance goals in subsequent years, the incentive plan is a hybrid plan because it has features of both annual and long-term incentives. An example would be a plan where awards are earned based on annual performance, but a portion of the award is "banked" for payout in two years, where the "bank account" balance could vary up or down based on performance in each of the following two years.

(n6)Footnote 6. Pearl Meyer & Partners report prepared for The Conference Board's 2005 Executive Compensation Seminar.

(n7)Footnote 7. Pearl Meyer & Partners report prepared for The Conference Board's 2005 Executive Compensation Seminar.

(n8)Footnote 8. Pearl Meyer & Partners report prepared for The Conference Board's 2005 Executive Compensation Seminar.

(n9)Footnote 9. Equilar 2009 CEO Pay Strategies: Compensation at S&P 500 Companies.

(n10)Footnote 10. Note that under FAS 123R, if the vesting condition requires the performance of future services only, the initial estimate of the service period for recognizing compensation cost is presumed to be the vesting period. If, however, the service condition vesting may be accelerated by a performance condition that is probable of attainment, the initial estimate of the requisite service period for recognizing compensation cost is based on the shorter performance period.

(n11)Footnote 11. *See* Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243.

(n12)Footnote 12. *See* § 15.05[2][c] below.

(n13)Footnote 13. On December 21, 2001, the SEC adopted rules that require new disclosure for all equity compensation programs of domestic public companies with respect to fiscal years ending on or after March 15, 2002. *See* SEC Release Nos. 33-8048, 34-45189; File No. S7-04-01. The new disclosure requirements include a table with separate disclosure for arrangements approved by stockholders and arrangements not approved by stockholders, as well as written descriptions of plans not approved by stockholders and a new requirement to file copies of these plans with the SEC. Companies must include the new disclosure in annual reports filed with the SEC and in proxy or information statements in years when a company submits a plan to stockholders for approval. As of November 2009, revised SEC disclosure rules are pending.

(n14)Footnote 14. *See § 8.03 above.*

(n15)Footnote 15. *See PM&P Trends and Issues Report: Top 10 Executive Compensation Issues in the New Economy (April 2009).*

(n16)Footnote 16. However, note that paying dividends as declared on unvested performance-based shares is considered a serious "problematic pay practice" by RiskMetrics.

(n17)Footnote 17. For example, in 2003 Progressive Corporation and Microsoft, among others, replaced stock option grants with restricted stock for a broad employee population.

(n18)Footnote 18. Exxon Mobil, for example, has made grants of career shares to its named executive officers (whose compensation is reported in the proxy statement).

(n19)Footnote 19. Unlike APB 25, FAS 123R generally does not require variable mark-to-market accounting for performance contingent stock awards. Instead, the expense is calculated based on the grant date value and accrued over the vesting period. The expense is "trued-up" for the actual number of shares that vest, but the expense attributable to such shares is nevertheless based on the grant date value. This "true-up" or expense reversal concept, however, does not apply for stock awards contingent upon a market condition (e.g., achievement of a stock price level or TSR).

(n20)Footnote 20. Under FAS 123R, however, for awards tied to market conditions (such as total shareholder return), those conditions will be considered when estimating the fair value of such an award, and previously recognized compensation cost for such an award cannot be reversed even if the market condition is not satisfied.

(n21)Footnote 21. A stock appreciation right, or SAR, is structured like a stock option, with an exercise price, a term of years, and vesting. Historically, SARs were very often paid in cash, not stock, and the transaction mirrors a cashless exercise, where the holder of the SAR receives cash equal to the appreciation without remitting the exercise price to the company.

(n22)Footnote 22. Under FAS 123R, dividend equivalents on shares must be expensed as compensation if they are paid regardless of the vesting of the underlying shares and if the underlying shares do not vest.

(n23)Footnote 23. Described in § 15.03[2][a][i] above.

(n24)Footnote 24. Under *IRC Section 83(b)*, an employee may elect to be taxed in the year of transfer rather than waiting until the property restrictions lapse. If the election is made, the employee is treated as recognizing ordinary income to the extent of the difference, if any, between the fair market value of the property without regard to any lapse restriction and the amount, if any, the recipient paid for the property. The election must be filed not later than 30 days after the date the property is transferred.

(n25)Footnote 25. *See Chapter 10, The Compensation Committee, above.*

(n26)Footnote 26. Misalignment can also occur if the measurement period is too long or too short, such as the use of new product development in an annual incentive plan when the research and development cycle is closer to five years.

(n27)Footnote 27. Moreover, under FAS 123R, any condition relating to attainment of a specified stock price or TSR will prohibit a company from reversing previously recognized compensation cost if the award is subsequently forfeited or reduced because such condition was never satisfied.

(n28)Footnote 28. *See § 15.05[1] below.*

(n29)Footnote 29. Comparison of total shareholder return relative to market and an industry or peer group index

was previously required disclosure in proxy statements (the "stock performance graph"), is no longer required under the revised proxy rules, and must now be included in the Annual Report on Form 10-K.

(n30)Footnote 30. This is readily apparent, for example, in the case of absolute stock price targets, which were easy to hit for many companies during the technology boom when a rising tide lifted all boats, even though a company's relative TSR performance may have been unexceptional.

(n31)Footnote 31. *See* PM&P Trends and Issues Report: Top 10 Executive Compensation Issues in the New Economy (April 2009).

(n32)Footnote 32. *See* PM&P Trends and Issues Report: Top 10 Executive Compensation Issues in the New Economy (April 2009).

(n33)Footnote 33. Preliminary results from the 2009/2010 Director Compensation Report by the National Association of Corporate Directors and Pearl Meyer & Partners.

(n34)Footnote 34. *See* The Informer, "*Roadmap for Compensation Risk Assessment: A review of pending regulation and the actions to help companies get prepared*" by Yvonne Chen (Autumn 2009).



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Corporate Governance: Law and Practice

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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

*2-15 Corporate Governance: Law and Practice § 15.04***AUTHOR:** Yvonne Chen and Deborah Lifshy**§ 15.04 The Cost of Recruitment****[1] Costs of Recruiting Senior Executives**

While excesses in executive compensation have commanded prominent attention in the press, from a corporate governance point of view it is equally important to bear in mind that there are upward pressures on executive compensation that boards and compensation committees ignore at the peril of shareholders. For example, one of the most difficult challenges for a board of directors is hiring a new CEO or key executive. The obvious costs of recruitment typically include an increase over the prior CEO's pay package, relocation expenses, business inefficiencies during the transition period to the new CEO, and executive search fees. Less obvious costs include one-time recruitment inducements like sign-on awards (cash, restricted stock or stock options), make-whole payments for forfeited compensation from a prior employer, and enhanced retirement benefits for mid-career hires. Such payments may be particularly costly because they are often linked to continued service, rather than performance. Yet, it is frequently difficult or impossible to recruit qualified CEOs and other senior executives of large public companies without incurring these costs. Boards and compensation committees may therefore quite properly authorize significant payments and expenses in connection with the recruitment of senior executives in the best interest of the companies and shareholders they serve. Nevertheless, it is significant to note that, in recent years, RMG has made recruitment of new talent even more difficult with its policy that regards overly generous new CEO pay packages (for example, excessive "make-whole" provisions) to be a "problematic pay practice."

Nevertheless, costs of recruitment can become excessive when the board "falls in love" with one candidate and the compensation negotiation becomes one-sided. Clearly, every board wants a highly qualified leader at the top. However, directors sometimes risk ending up with a Rolls Royce when they walked into the showroom looking for--and probably could do as well with--a compact. Ratcheting up compensation for the CEO job makes sense only if the company is "trading up" with the expectation that the new leader will take it to the next level. Even so, most companies cannot afford to pay above-market rates for the entire executive team.

[2] Standard Company Executive Plans Plus Make-Whole for Amounts Forfeited

When a seasoned executive is being recruited away from another corporation, there are a number of factors the new company should consider before making the offer. The company will need to understand the executive's current total

compensation package and whether the executive will be forfeiting a bonus, long-term compensation plan benefits or unvested equity (restricted stock or options). Often, the most expensive item for mid-career hires is a make-whole arrangement for lost pension entitlements--an arrangement which RMG views as a "problematic pay practice." In many cases, the new executive will also want to negotiate a total package that is bigger and better than the outgoing executive's package.

[3] Additional Recruitment Inducements

[a] Contracts With Guarantees

Often senior executives expect inducements in addition to the agreed-upon salary and the company's standard benefits package (perhaps enhanced by a make-whole provision to compensate the executive for pension benefits left behind at the old company), especially if the new position is a lateral move. CEOs and other very senior officers often negotiate for employment contracts.

When the contract is negotiated in the recruitment process (as opposed to being given to an executive for the first time upon promotion to a more senior position in the company), the executive may expect a guarantee of a minimum annual salary for a certain number of years (typically three). Often, these contracts guarantee that the executive's annual salary will be reviewed by the board annually for increases, but may not be reduced during the guaranty period. Similarly, some contracts guarantee a minimum bonus payout for a certain number of years during the term of the agreement. However, RMG considers any contract with a multi-year guarantee for salary increases, bonuses and equity compensation to be examples of an "egregious employment contract" and considers such to be a "problematic pay practice."

[b] Mega Grants of Restricted Stock or Stock Options

Upon initial hire, many companies will offer an executive a large one-time grant of restricted stock or stock options to give the executive an immediate equity stake. This is arguably a poor practice from a corporate governance perspective, since executives in even average and poor performing companies can still do quite well and, if the initial grant includes restricted stock (without performance vesting), the reward the executive receives will be mostly unrelated to performance. In addition, a mega grant of options enables executives to realize significant gains from even small increases in share price, based purely on the number of shares they hold,ⁿ¹ not to mention windfalls that may result in the event of a change in controlⁿ² or dismissal of an underperforming CEO.ⁿ³ On the other hand, equity awards with vesting conditions may be a better alternative than an immediate cash hiring bonus. It should be noted, however, that if the disclosure rules are amended to show grant date values in the summary compensation table of the proxy statement, awarding a mega-grant to an executive could have a profound impact on the executive's "Total Compensation" number and influence who are the named executive officers (other than the CEO or CFO) for any given year.

[c] Termination Protections under Golden Parachutes

In addition to offering generous pre-change in control severance benefits, recruiting companies are generally expected to provide incoming executives at very senior levels with severance benefits (usually including, at a minimum, a lump-sum severance payment that is a multiple of the executive's annual base salary or salary plus annual bonus) in the event their employment is terminated following a change in control (often referred to as "golden parachute" or change-in-control agreements).ⁿ⁴

In the 1980's, a period of intense corporate takeover activity, Congress became alarmed about excessive golden parachutes to top executives and other key personnel in connection with such takeovers. Many believed that golden parachute contracts did little but assist an entrenched management team to remain in control, and may have provided corporate funds to subsidize officers or other highly compensated individuals. In an effort to thwart the adverse corporate governance impact of such parachutes, Congress enacted a penalty for such excesses through *IRC sections*

280G and 4999. These sections provided that no deduction is allowed for any "excess parachute payment," and the executive must pay (and the corporation must withhold) a nondeductible 20 percent excise tax on any excess parachute payment.ⁿ⁵ Ironically, the impact of this regulation seemed to cause a boomerang effect in that companies that had not provided for high multiples of severance payouts following a change in control amended their executive agreements to provide protection up to the maximum amount payable under the regulations without triggering the excise tax, and many of those with high multiples elected to "gross-up" for the excise tax.

Many argue that golden parachutes are actually advantageous from a corporate governance standpoint, as they can benefit the corporation and its shareholders by reducing the conflict of interest between shareholders and managers at the time of the takeover and can make it more likely that the efficiency gains from the takeover are realized. They are also arguably an efficient device for attracting and retaining executives, providing desirable insurance against termination especially in firms where a future merger is probable. "But at the same time, a golden parachute could be used to restrict takeovers and entrench management at the expense of shareholders" by making the takeover so expensive that the golden parachute functions as a deterrent to a deal that would benefit shareholders.ⁿ⁶

With RMG's adoption of a new policy characterizing the making of employment agreements (or modifications to employment agreements) that contain gross-up provisions as a "problematic pay practice," the prevalence of the gross-up--at least for new contracts--may be on the decline. In the 2009 proxy season, RMG appeared to strictly took a strict line, consistently recommending votes against directors or equity plans of companies that had entered into or materially amended contracts with gross-up provisions. In fact, the most common reason for withhold votes for compensation committee members in 2009 was the inclusion of a tax gross-up in a new or modified employment contract.

[d] Retirement Benefits for Mid-Career Hires

Defined benefit pension plans typically calculate an executive's pension benefit by multiplying the executive's final average pay near the end of his career by an annual percentage for each year of service with the employer. A mid-career hire with escalating pay year-over-year can suffer a significant reduction in pension benefits if his years of service with the former employer are ignored when it comes time to calculate pension benefits based on final average pay with the new employer. Even if pension benefits with the former employer are vested, it is highly unlikely that the sum of the standard pension benefits at the former and new employer will equal (or perhaps even approach) the pension benefits the executive could have earned by continuous employment with one employer. Accordingly, a new employer seeking to recruit a top executive in the middle of his career may have to offer enhanced retirement benefits.

A new employer may agree by contract to credit the newly hired executive with additional age and service credits under its existing or supplemental executive retirement plans. For example, if a plan requires that the company employ an executive for five years before his retirement benefits vest, the company will give the executive extra service credit for this purpose. If the plan contains a formula whereby the executive's benefits are based on final average pay and years of service with the company, tacking on additional credit will result in higher benefit payouts, as well. Nevertheless, the National Association of Corporate Directors' ("NACD") Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, recommends against adding years onto an executive's years of employment to increase the executive's retirement package.ⁿ⁷ Likewise, RMG considers such crediting to be a "problematic pay practice".ⁿ⁸ The proxy disclosure rules adopted by the SEC in 2006 require companies to identify instances where extra years of service are provided to named executive officers and to quantify the resulting benefit augmentation.

Pension benefits lost in a mid-career move can be substantial and will invariably become a part of the negotiation between the executive and the new employer. A blanket admonition against adding years of service ignores market realities. In the end, it is a matter of money. The issue can be solved by adding years of service or paying more for something else instead. Either way, from a corporate governance perspective, the compensation committee should be made aware of the recruitment costs associated with the restoration of retirement benefits for a mid-career hire.

[4] Drawing the Line on the Cost of Recruitment

If a company is in dire need of a capable CEO and the preferred candidate is adamant about receiving a certain level of compensation to come on board, the company may feel powerless to say no. From a corporate governance point of view, it is critical that, at every stage of the negotiations, the compensation committee understands the cost of the bid and the ask.

From a practical perspective, it is not in the company's best interest to be left with only one viable candidate for the CEO position. While it may be necessary to pay more than the predecessor CEO if the objective is to "trade up," the compensation committee should keep an eye on the total cost of the package demanded at every stage of the negotiations and should be aware of how it compares with the cost of the incumbent's package and with market norms. If the cost of the package demanded significantly exceeds the cost of the predecessor package or exceeds the market competitive 75th percentile, the compensation committee should take a step back and reconsider whether there is not another qualified candidate without inflated compensation demands.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Compensation Bonus & Severance Pay Business & Corporate Law Corporations Directors & Officers Compensation Salaries

FOOTNOTES:

(n1)Footnote 1. One example was highlighted in The Wall Street Journal: "Gillette's Stock Gains Means Huge Windfall for CEO Kilts," Wall St. J., Jan. 5, 2004.

(n2)Footnote 2. For example, Gillette's acquisition by P&G will result in a payout to Gillette's CEO Kilts as high as \$185 million, much of which is attributable to the large amount of his Gillette stock ownership. *See In a Lather Over the Gillette Deal*, Business Week Online, June 16, 2005.

(n3)Footnote 3. Several large severance packages included the value of substantial gains on equity. For example, Stanley O'Neal of Merrill Lynch, Charles Price of Citigroup, Bob Nardelli of Home Depot and Hank McKinnell of Pfizer recognized values of \$121 million, \$12 million, \$7 million and \$11.6 million that were attributed to their restricted stock and stock option awards. *See "Underperforming CEOs with Multimillion-Dollar Payouts"*, Morningstar News, November 28, 2007.

(n4)Footnote 4. *See § 15.06[1] below.*

(n5)Footnote 5. *IRC §§ 280G and 4999* are discussed in greater detail in *§ 16.02[2] below.*

(n6)Footnote 6. Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?* 21 *Va. Tax Rev.* 125, 129 (2001).

(n7)Footnote 7. NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, Appendix F, at 55 (2007) ("Do not 'add years' of service on to an executive's employment in order to increase the executive's retirement package."). This Appendix F, "Guidance Pertaining to Executive Employment Contracts," is reproduced in Appendix 16-C to Chapter 16 *below.*

(n8)Footnote 8. *See* RMG Governance Services US Corporate Governance Policy 2010 Updates at page 26 (November 19, 2009).



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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

*2-15 Corporate Governance: Law and Practice § 15.05***AUTHOR:** Yvonne Chen and Deborah Lifshey**§ 15.05 The Cost of Retention****[1] Costs of Retaining Senior Executives**

When *Section 162(m) of the Internal Revenue Code ("IRC 162(m)")* was adopted in 1993, lawmakers expected that the growth of executive pay would slow due to the \$1 million cap on the deductibility of non-performance-based pay.ⁿ¹ While many companies did limit executive salaries to \$1 million or less, other performance-based elements like annual incentives, stock options and long-term performance incentive plans have accelerated to the point where, in 2008, salaries often represented as little as 11 percent of the pay mix for CEOs.ⁿ² The unintended consequence is that salary alone may no longer provide sufficient retention value, especially given the shortened time horizon of some executives and the trend away from defined benefit retirement programs.

In a slow-growth economic cycle, when corporate profits are weak, equity-based incentives (stock options and restricted stock) produce less significant wealth for senior executives than they do in an up cycle. In this circumstance, in which companies still have a tax incentive to cap base salary at \$1 million, there is often pressure to jigger incentive plans to keep senior executives' total compensation at historical levels despite declines in corporate performance. The rationale is often that executives should not be penalized for the negative impact of market forces beyond their control and that only superior executive talent can deliver meager results in a challenging business environment. However, lowering performance thresholds to promote retention in a difficult market environment is in direct conflict with a pay-for-performance philosophy. In addition, the implicit assumption of this approach seems to be that it is necessary for retention purposes to keep executive compensation up in bad times as well as good. This assumption ignores the fact that, in a weak economy, executives' opportunities to make more money by changing employers is limited, since all companies (or all companies in a sector) are operating with the same market constraints.

Even when performance is good and incentive plans designed to provide a retention hook are working, companies may succumb to retention pressure. For example, a few executives have been able to negotiate special awards upon re-signing or renegotiating employment contracts. As with the price of recruitment, the price of retention can become excessive if the compensation committee is unable to negotiate with the executive from a position of strength.

[2] Salary

As a result of *IRC Section 162(m)*,ⁿ³ many public companies now informally limit base salary to a maximum of \$1 million, with remaining compensation included in "performance-based" incentive compensation. Some major companies have exceeded this limit for chief executive officers to varying degrees, with the company accepting the loss of the deduction in exchange for providing the desired guaranteed compensation level for its CEO. At other companies, the Section 162(m) limit may be avoided by automatically deferring payment of the extra compensation until after the executive's employment is terminated.

Due to rising levels of incentive pay over the past 10 years and the common practice of limiting each named executive officer's salary to \$1 million, CEO salaries have now fallen to about 11 percent of the overall pay mix.ⁿ⁴ At such a small percentage of overall compensation, salary alone cannot provide sufficient retention value for a capable top executive. For better or worse, some companies with depressed performance and little or no annual incentive award value have increased the size of annual restricted stock or stock option grants as a way of addressing the retention issue, while others have been forced to change the annual incentive plan payout formula.ⁿ⁵

[3] Handcuffs

There are a variety of compensation tools that may be used to induce an executive to stay with a company. Equity-based incentive awards are typically subject to vesting restrictions that span three to five years. However, the most effective retention factors are often non-compensatory, such as strong company performance and clear career advancement prospects.

In consideration of large retention awards, executives may be required to sign agreements not to compete or not to solicit employees or customers for a period of time after leaving the employ of the company (and, in the case of non-compete agreements, within a defined universe of competitors or a stipulated geographic area). Such contracts often have "clawback" provisions, under which the company has a right to recover some or all of the award if the executive breaches the covenant not to compete or not to solicit employees.ⁿ⁶ In some states, employee non-compete or non-solicitation agreements may not be enforceable unless the executive attempts to compete by using trade secrets or proprietary information of the company or has furnished services of a unique or extraordinary character.ⁿ⁷ In addition, even when the underlying non-compete or non-solicitation clause is enforceable, the "clawback" provision may be attacked as an unenforceable liquidated damages clause.ⁿ⁸

One drawback of significant retention awards is that they represent an investment in the future on the basis of an assumption about who the key contributors will be. Companies are not always prescient about who will be the key contributors, and so retention awards carry an element of risk that retrospective pay-for-performance programs do not.

Retention programs are designed to keep the most critical strategic contributors who are also "at risk" of recruitment by competitors. The purpose is not to provide incremental compensation for all executives at a certain level. In the selection process, the company must make difficult judgments (not only about who are the key contributors but also about who is most at risk of being recruited away) that may not be perceived as fair by ostensibly similarly situated executives who do not receive retention awards. (Confidentiality agreements are helpful but not necessarily airtight in the executive suite.)

Whenever a company makes retention awards, it should consider whether there is a risk that another "one-time" retention program will be needed to keep executives when the initial awards vest. Finally on this subject, although some long-term incentive awards carry prorated or accelerated vesting upon retirement, an executive who retires before the special retention award is fully vested has not delivered the required length of service and generally should not be permitted to vest.

[a] Restricted Stock or Career Stock Grants

Restricted stock grants can be an effective retention vehicle as part of the regular compensation program. For example, several of the major investment banks pay a portion of what was historically an annual cash bonus in the form of restricted or deferred shares. The percentage of compensation that is paid in shares increases as compensation levels increase. The plan serves as a retention handcuff since shares are forfeited if the executive voluntarily terminates employment before full vesting; each year a new "layer" of shares is added to continue the retention effect.

Companies may also choose to make restricted stock or career stock grants with lengthy vesting schedules (10 years or more) to retain executives for a longer tenure. Career stock grants generally vest upon retirement.⁹ Since the stock is a "full value" instrument (unlike a stock option where value depends on appreciation over the exercise price), such awards have high retention value.

With the intense focus of policy makers, government officials and shareholder activists on ensuring that executive compensation is tied to long-term value creation and aligning payouts with risk horizons, there will be increased pressure on companies to award career stock grants and stock that does not vest until retirement, as well as to adopt stock holding requirements until or even beyond retirement. There will also be pressure to require executives to defer bonuses (whether in the form of stock or cash) over several years (known as "bonus banking").

[b] Stock Ownership or Retention Guidelines

Stock ownership or retention guidelines may be used to align executive compensation with the long-term interests of stockholders. A stock ownership guideline typically requires senior management (and often directors) to acquire and retain a meaningful amount of the corporation's stock. Ownership guidelines are typically stated as a multiple of salary (in which case it is necessary to specify as of what date the stock price is measured--date of purchase or later date such as year-end, when compliance with stock ownership guidelines is tested). For more volatile stocks, the ownership guideline may be stated as a number of shares. In fact, following the economic turndown of 2008, many companies were forced to consider restating their guidelines in terms of shares, as executives failed to meet the stock ownership guidelines based on percentages of annual base salary because of depressed share prices. Stock retention guidelines typically require the executive to hold all or a portion of stock acquired from the company's compensation program for a certain period of time.¹⁰ If a retention guideline is established, executives may decide to exercise options early in order to "start the clock" on the retention or restriction period. In establishing these guidelines, the compensation committee should ensure that the financial investment and risk entailed in complying with these guidelines is not so substantial as to diminish the competitiveness of the total compensation package. The existence of stock ownership guidelines probably does not impair a company's ability to recruit or retain executives, since many companies have ownership guidelines in place. About 78 percent of large companies disclose formal share ownership guidelines.¹¹

Other considerations surrounding stock ownership and retention guidelines include whether there are penalties ("sticks") for non-compliance, such as reduction or loss of eligibility for future long-term incentive grants, or payment of annual incentives in shares rather than cash until guidelines are met; and whether the company assists the executive in accumulating shares and offers special rewards ("carrots") for executives who achieve and maintain specified ownership levels, such as grants of additional shares if the executive elects to receive annual incentive in the form of restricted shares.

[c] "Clawback" Provisions

Executives may be required to sign an agreement providing for the forfeiture of their interest in incentive plans, equity plans, non-qualified retirement plans and deferred compensation arrangements if they violate a restrictive covenant. For example, a company may terminate a former executive's right to exercise stock options if he or she leaves the company and then engages in competition with the former employer. As equity has become a dominant part of executive pay packages, companies have also used the "clawback," which generally requires an executive who violates a restrictive covenant to pay back to the company any profit on the exercise of options or vesting of restricted stock. The look-back

period typically runs from six months to one year from the date of exercise of the option or vesting of the restricted stock. This type of provision may also be referred to as a "bad boy" clause. Clawbacks may be attacked in litigation as unenforceable liquidated damages clauses.ⁿ¹²

[4] Less Obvious Costs of Retention

[a] Contract Renewal Bonuses/Awards

In consideration for signing a new agreement (or renewing an expiring agreement) to continue employment with a current employer, an executive may request a renewal bonus or other retention award. Such awards should be reviewed to ensure that their purpose and size is reasonable in relation to the extended tenure. If possible, compensation committees should avoid authorizing contract renewal awards. In most cases, there are already meaningful retention inducements for an incumbent executive, such as forfeiture of unvested equity awards.

[b] Low Performance Thresholds

Due to the \$1 million cap on deductible compensation for named executive officers under *IRC Section 162(m)*, some companies try to increase the amounts payable under incentive compensation plans (which are exempt from the cap if they meet the requirements for qualified performance-based compensation plans). To maintain the deduction under the "performance-based" exception in *IRC Section 162(m)*, some companies set very low performance thresholds so that payouts under these plans are likely to be made.

[c] Extra or Increased Stock-Based Awards to Compensate for Reduced Cash Awards When Performance is Poor

If a company is not paying cash bonuses necessary to ensure an executive's retention, it may also turn to larger or more frequent equity-based awards. A low or no bonus year may be softened with a restricted stock or option grant. The compensation committee should understand that the objective for such awards is retention, as opposed to a pay-for-performance philosophy.

[5] Drawing the Line on the Cost of Retention

All retention incentives assume of course that the executive is likely to accept another job if the incentives are not paid. Compensation committees should be skeptical of self-serving positions taken by executives who claim to be highly marketable or who claim they are being recruited by prospective employers. Especially when annual and long-term incentives are not paying as well as previously because the economy is in the doldrums, the ultimatums of these "grass-is-greener" executives should often be regarded with suspicion. In addition, the ability to pay retention bonuses in the context of a bankruptcy filing has now been severely curtailed with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.ⁿ¹³

On the other hand, compensation committees should not wait to actually lose critical talent before concluding that retention incentives are appropriate. It may be in the best interests of the company and its shareholders to be proactive rather than reactive in these circumstances, especially where the compensation committee concludes that the executives in question are critical to the company's success and not easily replaced.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Directors & Officers Compensation General Overview Business & Corporate Law Corporations Directors & Officers Compensation Bonus & Severance Pay Business & Corporate Law Corporations Directors & Officers Compensation Salaries Tax Law Federal Income Tax Computation Deductions for

Business Expenses Business, Entertainment & Trade Expenses (IRC secs. 162, 274)

FOOTNOTES:

(n1)Footnote 1. *See § 10.06[3] above* for discussion of *IRC Section 162(m)*.

(n2)Footnote 2. Equilar 2009 CEO Pay Strategies: Compensation at S&P 500 Companies.

(n3)Footnote 3. *IRC Section 162(m)* provides that there is no corporate income tax deduction for compensation over \$1 million paid to the CEO and the other four most highly compensated executive officers, with certain significant exceptions. *See §§ 10.01, 10.05[1][a], 10.06[3], above.*

(n4)Footnote 4. Equilar 2009 CEO Pay Strategies: Compensation at S&P 500 Companies.

(n5)Footnote 5. *See § 15.05[3] below.*

(n6)Footnote 6. Used in this context, "clawbacks" refer to techniques to enforce post-employment covenants, rather than requirements to repay compensation paid based on inaccurate financial statements, as per TARP and Sarbanes-Oxley regulations.

(n7)Footnote 7. *See, e.g., TMP Worldwide v. Franzino, 703 N.Y.S.2d 183 (N.Y. App. Div., 1st Dep't 2000)* (refusing to enforce a covenant not to compete because "there is no indication that the individual defendant had access to, much less misappropriated, customer lists, trade secrets, business plans or other confidential information, or that his services at plaintiff's company were of a unique or extraordinary character.") *but see Battenkill Veterinary Equine P.C. v. Cangelosi, 768 N.Y.S.2d 504, 506 (N.Y. App. Div., 3d Dep't 2003)* (enforcing a veterinarian's three-year agreement not to compete within 35 miles of employer's clinic because the covenant was "reasonably limited in time, geographic area and scope, ... necessary to protect the employer's interests, not harmful to the public and not unreasonably burdensome.").

(n8)Footnote 8. *See, e.g., Fingerlakes Chiropractic, P.C. v Maggio, 703 N.Y.S.2d 632 (N.Y. App. Div., 4th Dep't 2000)* (holding that non-compete clause was enforceable but liquidated damages clause for breach of non-compete was unenforceable).

(n9)Footnote 9. For example, Whirlpool Corporation has a "Career Stock Program (the 'Career Stock Program')". The Career Stock Program was established to provide one-time grants of phantom stock to select key executives as a means of retaining those executives and encouraging long-term employment. Recipients and award sizes are based on subjective determinations relating to a broad range of factors. The shares do not represent an equity interest in Whirlpool, and no voting rights attach to the shares until and unless they are distributed to the participant. Grants are made under one or more of Whirlpool's Omnibus Stock and Incentive Plans. The value of a share of Career Stock on any given date is equal to the fair market value of a share of common stock on that date. Recipients of Career Stock will receive one share of common stock for each share of phantom stock on a one-for-one basis upon retirement after attaining the age of 60 or upon termination of employment, based on individual vesting schedules and subject to certain non-competition provisions. Phantom Career Stock dividends are invested in additional phantom shares to be awarded in the same manner as the original awards." Whirlpool Corporation Proxy Statement dated March 11, 2003.

(n10)Footnote 10. For example, Citigroup expected its "directors and senior management, approximately 120 individuals in all, [to] have entered into a *stock ownership commitment*, which provides that each of such individuals will hold at least 75 percent of all Citigroup common stock owned by him or her on the date he or she becomes subject to the commitment and awarded to him or her in the future, subject to certain minimum ownership guidelines, as long as he or she remains a director or member of senior management." In 2005, it expanded its ownership commitment guidelines to include a "25% holding requirement that applies prospectively and generally covers those employees who report directly to a member of the Citigroup management committee and those employees one level below them." After this guideline becomes in effective in 2006, approximately 3,000 employees around the world will be subject to the

Citigroup's stock ownership commitment. Citigroup Inc. Proxy Statement dated March 15, 2005.

(n11)Footnote 11. Equilar 2008 Executive Stock Ownership Guidelines Report.

(n12)Footnote 12. *See, e.g., Fingerlakes Chiropractic, P.C.v Maggio, 703 N.Y.S.2d 632 (N.Y. App. Div., 4th Dep't 2000)* (holding that non-compete clause was enforceable but liquidated damages clause for breach of non-compete was unenforceable).

(n13)Footnote 13. *See 11 U.S.C. § 503(c)(1)*, as *added by* Pub. L. No. 109-8 (2005), effective with respect to cases filed on or after October 17, 2005.



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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

2-15 Corporate Governance: Law and Practice § 15.06

AUTHOR: Yvonne Chen and Deborah Lifshy

§ 15.06 The Cost of Termination and Smooth Transition

[1] Costs of Senior Executive Turnover

Turnover in key executive positions makes headlines partly because it is often viewed as a sign of trouble. Companies can protect against some of the negative impacts of key executive turnover by imposing restrictive covenants such as non-competition, non-solicitation, non-disclosure and non-disparagement clauses, and by demanding "clawback" of compensation when the executive engages in restricted activities. However, these provisions may be difficult or costly to enforce and the parties may end up in court.

Other costs of turnover that are more difficult to offset include executive search fees, business inefficiencies during the vacancy, missteps during the new hire's learning curve, loss of corporate memory and poor morale. Even when turnover is desirable to make room for new managers in the succession plan or to remove poor performers, the compensation committee will be called upon to make decisions regarding the departing executive's exit package.

"Big ticket" items in exit packages include severance payments, accelerated vesting of equity-based incentive awards or additional credit in determining pension benefits. These items may be quite costly, particularly in the context of an executive whose employment is terminated for poor performance.ⁿ¹ While employment agreements often restrict or eliminate payments/benefits if an executive is terminated for "Cause" (a carefully defined term in the executive's employment agreement), poor performance is rarely included in the definition of Cause. In the extreme, a company may pay more for failure than for good performance when the executive being dismissed receives compensation and benefits beyond that paid to continuing employees.ⁿ²

Companies and their compensation committees may also be called upon to negotiate and approve "golden sunset" packages for retiring executives. These post-termination arrangements, which are not prevalent and are tailored to the specific situation, represent an incremental cost to the company, since they are almost always in addition to what the executive is entitled to receive under the company's existing compensation programs. Examples of special retirement benefits may include sweetheart consulting arrangements, accelerated vesting of equity-based incentive awards, extended post-termination exercisability of stock options, enhanced retirement and other benefits, continued access to company perquisitesⁿ³ or other types of recognition, such as charitable donations and endowments, scholarships, etc.

With the enactment of *IRC Section 409A*, however, changes to features relating to acceleration or other substantive terms and conditions of a plan providing for "deferred compensation" within the meaning of the statute may result in substantial penalties. Likewise, RMG considers excessive severance or change-in-control arrangements to be "problematic pay practices" by RMG. Although the rationale for these deals is questionable, legitimate consulting arrangements may withstand scrutiny. In some instances, the compensation committee may simply be giving the retiring executive a significant "pat on the back" for a job well done, not unlike the proverbial gold watch awarded at the retirement dinner party-but in this instance of a potentially much greater value.

[2] Employment Contracts, Severance Agreements and Golden Parachute Agreements

The most significant issue addressed in a typical employment agreement is unemployment--that is, what happens if the employment relationship is terminated because of breach, disability, death, involuntary termination by the company without Cause, or voluntary termination by the Executive with "Good Reason." A good executive employment agreement deals with these various categories of employment termination, the provisions relating to each of which are often subject to extensive negotiations when a company brings in a new senior executive.

The NACD Blue Ribbon Commission on Executive Compensation recommends that, in hiring a new CEO from the outside, the compensation committee should hire special counsel to prepare any employment agreement on behalf of the committee.ⁿ⁴ The NACD Report also suggests that, before agreeing to an employment agreement, the committee review company costs under a "worst case" severance benefit.ⁿ⁵

The use of employment agreements has been fueled by the increased mobility of top executives and the proliferation of tax, securities, accounting and transaction-related issues.ⁿ⁶ The increased use of employment contracts also reflects high levels of involuntary termination of senior executives' employment.ⁿ⁷ Shareholder intolerance for under-performance has resulted in a very short "proving" period for newly appointed CEOs and other leaders. As a result, severance protection has become a form of insurance for executives to protect against the prospect of a career-ending dismissal.

The term "employment agreement" is often used interchangeably with the terms "severance agreement," "change in control agreement," and "golden parachute agreement." All three types of agreements (employment; severance; and change in control or "golden parachute") may contain similar provisions. However, an employment agreement typically is a more general document with provisions addressing basic employment issues such as the term of employment, salary and benefits. It may set out the employer's responsibilities if the executive's employment is terminated or there is a change in control of the employer, although termination of employment following a change in control is often addressed in a separate change in control or "golden parachute" agreement.

A severance agreement, in contrast, is characterized by its focus on the employer's obligations in the event an executive's employment is terminated and is sometimes negotiated, drafted and signed after a decision has been made to terminate the executive's employment. A change in control agreement deals with payments and benefits the employer is obligated to provide following a change in control or in the event of termination of employment following a change in control (also referred to as "golden parachute payments").

[3] Corporate Governance Perspective

There are several excellent treatises discussing the common provisions and drafting tips to consider when preparing employment contracts, severance agreements and golden parachute agreements.ⁿ⁸ Others have researched the market prevalence of different severance triggers, severance multiples, golden parachute "gross-ups" and other features sometimes found in such agreements.ⁿ⁹

From a corporate governance perspective, compensation committees should consider whether such agreements are in

the best interests of the company and its shareholders and how RMG and significant institutional shareholders will view such arrangements. As previously discussed, employment contracts or golden parachute agreements may be needed to recruit or retain key executives.ⁿ¹⁰ All too often, however, it appears that compensation committees approved agreements that seem decidedly one-sided in favor of executives. "A major frustration for shareholders and boards alike is CEOs who leave the organization, either by choice or at the request of the board, after short and/or unsuccessful tenures, and walk away with significant financial rewards."ⁿ¹¹

Payment for failure should not exceed payment for performance. The Business Roundtable cautions that "[p]articular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment. Corporations should not offer excessive severance packages that reward executives who have not met performance goals and objectives during the term of their employment."ⁿ¹²

The NACD has published a list of "best practice" guidelines for compensation committees to consider when reviewing proposed employment contracts or golden parachute agreements.ⁿ¹³ Among the more significant recommended practices are the following:

- in hiring a new CEO from the outside, employing special counsel to prepare any employment agreement on behalf of the committee;
- not treating non-renewal of a contract as an automatic trigger for severance pay;
- not extending severance benefits beyond the executive's age 65 or the company's normal retirement date;
- before agreeing to an employment agreement, reviewing company costs under a "worst case" severance benefit;
- expanding the definition of "for cause" termination to include violations of the company's code of business conduct and ethics, as well as violations of its insider-trading policies; and
- conditioning severance payments on the executive's agreement to standard "no compete, no raid, no sue, no tell" provisions.

In golden parachute agreements or change-in-control provisions, the NACD suggests that accelerated vesting of stock options or equity grants should not occur automatically, except in the event of a cash buyout where there is no equity conversion for shareholders, or upon involuntary termination of employment without cause (and presumably voluntary termination with good reason) following a change in control. The NACD also suggests refraining from "single trigger" severance benefits and urges companies to periodically review total company costs, and compare such costs to the company's total equity market capitalization.ⁿ¹⁴

Legal Topics:

For related research and practice materials, see the following legal topics:
 Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral OverviewBusiness & Corporate LawCorporationsDirectors & OfficersCompensationBonus & Severance PayBusiness & Corporate LawCorporationsDirectors & OfficersCompensationSalariesLabor & Employment LawEmployment RelationshipsEmployment ContractsConditions & TermsCompensation

FOOTNOTES:

(n1)Footnote 1. Take, for example, the departures of Stanley O'Neal from Merrill Lynch, Charles Prince from

Citigroup, Bob Nardelli from Home depot, and Hank McKinnell from Pfizer, whose estimated severance payouts totaled \$160 million, \$42 million, \$210 million and \$205 million, respectively. *See* "Underperforming CEOs with Multimillion-Dollar Payouts", Morningstar News, November 28, 2007.

(n2)Footnote 2. The dramatic fall in MCI stock price and subsequent bankruptcy filing resulted in a situation where those dismissed early received more value from their severance packages than did employees surviving the first reduction in force. *See* Shawn Young, *WorldCom's Ex-Employees Suffer Loss of Severance, Health Insurance*, Wall St. J., Sept. 20, 2002.

(n3)Footnote 3. Our favorite is the courtside Knicks tickets for retiring General Electric CEO Jack Welch.

(n4)Footnote 4. NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, Appendix F, at 55 (2007). This Appendix F, "Guidance Pertaining to Executive Employment Contracts," is reproduced in Appendix 16-C to Chapter 16 *below*.

(n5)Footnote 5. *See* NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, Appendix F, at 55 (2007); reproduced in Appendix 16-C to this treatise.

(n6)Footnote 6. Research by Equilar reveals that of the PM & P Top 200 companies, 196 CEOs (98 percent) had some form of employment contract or severance agreement. Equilar broadly defines "employment agreement" as any change in control, severance, and other compensation or employment-related arrangement as generally discussed in proxy statements.

(n7)Footnote 7. *Executive Pay: A Special Report*, N.Y. Times, Apr. 9, 2006 (*citing* a report in which Pearl Meyer & Partners analyzed data from 200 large public companies (selected by the New York Times) that had filed proxy statements with respect to compensation paid in 2005).

(n8)Footnote 8. *See, e.g.*, Michael Sirkin and Lawrence Cagney, *Executive Compensation* (2007); Yale Tauber & Donald Levy, *Executive Compensation* (2007).

(n9)Footnote 9. *See, e.g.*, Robert Salwen & Gail McGowan, *Executive Employment Contracts* (Executive Compensation Advisory Services, 2002); Richard Alpern & Gail McGowan, *Guide to Change in Control: Protecting Companies and Their Executives* (Executive Compensation Advisory Services, 2002).

(n10)Footnote 10. *See* §§ 15.04 and 15.05 *above*.

(n11)Footnote 11. NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at 30 (2007).

(n12)Footnote 12. Business Roundtable, *Executive Compensation: Principles and Commentary* at 9 (Nov. 2007) (reproduced in full as Appendix 15-A to this chapter).

(n13)Footnote 13. NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, Appendix F, at 55 (2007). This Appendix F, "Guidance Pertaining to Executive Employment Contracts," is reproduced in Appendix 16-C to Chapter 16 *below*.

(n14)Footnote 14. NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, Appendix F, at 55 (2007). This Appendix F, "Guidance Pertaining to Executive Employment Contracts," is reproduced in Appendix 16-C to Chapter 16 *below*.



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Corporate Governance: Law and Practice

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CHAPTER 15 EXECUTIVE COMPENSATION: THE PERSPECTIVE OF THE COMPENSATION CONSULTANT

2-15 Corporate Governance: Law and Practice § 15.07

AUTHOR: Yvonne Chen and Deborah Lifshy

§ 15.07 The Consultative Process--Lifting the Veil

As part of the SEC disclosure requirements, the name of each compensation consulting firm used by the compensation committee is now public information, along with a discussion of its role in the compensation committee's executive compensation decision process. Advice that was once provided "behind closed doors" has garnered particular attention as shareholders, investor advisory groups, the media and other external parties have looked to hold accountable all those responsible for egregious pay practices. As a corollary, the compensation committee is increasingly influenced, rightly or wrongly, by how its pay decisions will "play in the public eye." Furthermore, the anticipation of a mandatory "Say-on-Pay" regime in the United States has resulted in more direct exchanges between the compensation committee and institutional investors. For example, Pfizer held a face-to-face meeting between its largest shareholders and its directors to discuss its compensation and governance policies. This section is intended to "lift the veil" on the current state of the consultative process and discuss possible directions for the future.

[1] Engaging the Compensation Consultant

Under NYSE listing requirements,¹ compensation committees of companies listed on the NYSE must now have sole responsibility for interviewing, selecting, engaging, directing, evaluating and terminating the engagement of the compensation consulting firm that advises the compensation committee. The compensation committee may ask management and the company's top human resources executive for input on specific consultants to consider and for assistance with the selection process. Although compensation committees may not hire the consulting firm that management favors, they generally would not hire a consulting firm that management opposes.

Ad hoc assignments are possible, but the compensation consultant is typically engaged to advise the compensation committee throughout the year, including in the annual review process for executive compensation. Thus, the scope of the consulting engagement may include:

- selection of the market benchmarking peer group and/or review of an existing peer group;
- collection and analysis of competitive market data (or review of data prepared by company human resources and/or finance staff) on:

- peer group compensation levels for similar executive positions;
 - relevant compensation survey data;
 - peer group program design practices, including the mix of pay elements, performance measures and the prevalence of key incentive plan design features;
 - peer group financial and stock performance data;
 - peer group shareholder dilution and annual share utilization levels;
 - review of existing incentive plan designs in the context of the company's business strategy;
- development of new or modified incentive plan designs;
 - assistance with the compensation risk assessment to ensure that the program does not encourage unnecessary or excessive risk-taking;
 - development of specific recommendations for individual executive compensation levels and annual adjustments to program structure, e.g., base salary merit increase budget and salary grade ranges, annual incentive target award levels and guidelines for long-term incentive and equity awards; and
 - assistance in the preparation of or review of the proxy disclosure materials, including the Compensation Discussion and Analysis section of the proxy statement; and other research projects, at the direction of the compensation committee.

Pursuant to its charter, the compensation committee may also have responsibility for making recommendations to the board regarding the non-employee director compensation program. If it does, the compensation consultant may also be requested to conduct competitive market/peer group evaluations on a periodic basis and assist in the design of the compensation program for non-employee directors. Alternatively, responsibility for the non-employee director compensation program may reside with the nominating and corporate governance committee and that committee may engage the same or a different compensation consultant.

The compensation consultant is normally expected to attend or be available for most compensation committee meetings and to have direct interaction with the committee chairperson between meetings. The compensation consultant would also typically have contact with the company's top management and human resources department as a necessary part of the engagement.

[2] Consultant Independence

As critics of excessive executive compensation become more sophisticated, they increasingly focused on the issue of consultant independence. Arguably, if the professional fees that a consultant receives for providing advice to management exceed the professional fees received for providing advice to the compensation committee, the consultant's independence from management could be called into question. For example, consider a consulting firm that is receiving millions of dollars in professional fees for assisting the company with outsourcing its benefits administration. If the same firm also advises the compensation committee on executive compensation (an assignment typically generates considerably less than \$1 million in professional fees), it is possible that the executive compensation consultant could be pressured into recommending excessive executive pay in order to avoid antagonizing the management team responsible

for awarding the larger outsourcing engagement.

Current SEC rules require companies to disclose, in their annual proxy statements, the name of the compensation consulting firm, as well as the scope of the engagement, the role of the consultant and the direction provided by the compensation committee. The proposed amendments to the SEC rules would additionally require, where non-executive compensation services are provided, that the following be disclosed:

- the nature and extent of any and all other services provided by the compensation consultant;
- the consultant's aggregate fees related to advising on executive and director compensation;
- the consultant's aggregate fees related to other services;
- whether management directly engaged, or otherwise participated in, the decision to engage the consultant for other services; and
- whether the board or compensation committee approved the other services.

Notably, the SEC does not prohibit consulting firms from advising both management and the compensation committee, although arguably the proposed disclosure may inhibit such practices. Relatively few companies currently voluntarily disclose information on professional fees paid to the compensation consultant,ⁿ² although a number of companies identify the compensation consultant as independent or address the degree to which the consultant provides services to management and the committee's approval process for such engagements.

Congress also took up the issue of consultant independence. In May 2007, Congressman Henry Waxman sent letters to six major compensation consulting firms requesting five years of historical information "regarding the executive compensation and other services" provided to each of the largest 250 U.S. companies. The letter requested confidential information on the total revenues charged to each of these companies and the breakout of revenues among executive compensation consulting services and "other services." Congressman Waxman's letter cited employee benefit plan and pension plan consulting as examples of "other services." All six targeted firms responded and Towers Perrin received a subpoenaⁿ³ for additional information as of June 2007.

In December, 2007, Congressional hearings were held with respect to the letters and the topic of conflicts of interests among compensation consultants. At the hearing, Congressman Waxman recommended that proxy statement disclosure include the full scope of compensation consultant relationships when the consultant is recommending executive pay.

At the same time period, a report was released by the Majority Staff of the Committee on Oversight and Government Reform,ⁿ⁴ which was based on the nonpublic information provided to the Committee in response to the inquiry letters sent to the six leading compensation consulting firms mentioned above. The report indicated that:

- over 100 large publicly traded companies hired compensation consultants with "substantial conflicts of interest" in 2006;
 - in 2006, at least 113 of the Fortune 250 companies received executive pay advice from consultants that were providing other services to the company;
 - some compensation consultants received over \$10 million in 2006 to provide other services;
 - over two-thirds of the Fortune 250 companies that hired compensation consultants with

conflicts of interest did not disclose the conflicts in their proxy statements (even though there is no such disclosure requirement);

- in 30 instances, a compensation consultant was identified as independent while being paid to provide other services to the company;

- consultants were paid nearly eleven times more for providing other services than they were paid for providing solely executive compensation services;

- there "appears to be" a correlation between the extent of a consultant's conflict of interest and the level of CEO compensation; in 2006, the median CEO salary of the Fortune 250 companies that hired compensation consultants with the largest conflicts of interest was 67 percent higher than the median CEO salary of the companies that did not sue conflicted consultants.

Most recently, H.R. 3269 has taken on the issue of consultant independence, requiring the SEC to issue standards for independence.

Increased attention to the independence issue may eventually result in the application or adoption of an "audit standard" for the compensation consulting industry. In addition to amended disclosure requirements, possible changes for the future may include:

- review and pre-approval by the compensation committee of any "other services" provided to the company by the committee's compensation consultants;
- standards of professional conduct relating to consultant independence;⁵
- annual certification of the consultant's independence;
- withhold votes for compensation committee members by investor advisory firms if the compensation consultant is not independent;⁶
- annual evaluation of the consultant's performance and review of professional fees by the compensation committee;
- periodic rotation of the consulting partner responsible for a specific client or periodic rotation of the consulting firm chosen as the compensation committee's advisor;
- increased prevalence of "dueling consultants" where the compensation committee and management each retain its own compensation consulting firm, with an increase in the combined cost of compensation consulting services; greater prominence of independent consulting firms that distinguish themselves by only serving compensation committees;
- a corresponding increase in the number of firms that focus on serving management (for example, when dealing with top executive contract negotiations, the compensation consulting industry is already bifurcated into smaller boutique firms that represent individual executives and firms that only represent employers;
- movement in the consulting industry away from a full service business model that combines executive compensation consulting with a wide variety of other services toward a business model that is

focused exclusively on providing services to the compensation committee or the board; and

- minimum fee requirements or special retainers for client companies where the compensation consultant is barred from providing any services other than those requested by the compensation committee.ⁿ⁷

While many of these ideas may help preclude the use of compensation consulting firms with compromised independence (real or perceived) and thereby reduce the risk of excessive executive pay, there are drawbacks with taking these ideas to an extreme. In the field of executive compensation, there are no uniform standards (such as Consultants' advice to the compensation committee involves professional experience and subjective judgment. Typically, there is no one right answer. Two independent consultants faced with the same set of issues could arrive at two completely different compensation programs, both of which may be reasonable and appropriate.

Nevertheless, some of the sorts of professional standards that now apply to the auditors may eventually be applied to compensation consultants. To impose limits on "other services" not related to the compensation committee that an independent consultant may undertake, policy makers would need to determine the appropriate balance. It will also be necessary to define "other services." Since most compensation committee charters do not limit the committee's purview to executive compensation alone, a consultant could remain free of conflict while providing services to the board that are not limited to executive or non-employee director compensation. If the audit standard were to serve as a model, then an independent consultant could provide "other services," as long as sufficient information were disclosed about the services provided and the cost in the preceding year of such services and of advice by the same firm to the compensation committee. RMG typically votes against the ratification of the appointment of an outside auditor whose fees for "other services" equal or exceed its fees for "audit and audit-related services." However, RMG has not yet addressed whether application of a similar "majority rule" for "other services" would be reasonable for an independent consultant advising the compensation committee. In practice, "majority rule" could be too lenient a standard and a limit on "other services" closer to 25 percent of total consulting fees might ultimately emerge. Most likely, RMG and others will develop policies regarding consultant independence once the SEC has released its final new regulations on consultant independence and related disclosures.

The costs of engaging "dueling consultants" may be prohibitive and unnecessary. In addition to the monetary cost of partly duplicative consulting engagements, companies with "dueling consultants" run the risk of creating an adversarial relationship between management and the compensation committee, or at least reducing the level of mutual trust. While reliance on multiple consulting firms for compensation survey data is commonplace and helpful, the use of "dueling consultants" could suggest that management and the compensation committee may have contradictory views about the company's compensation objectives, a situation that is generally not sustainable long term. Looking again to the "audit standard," although a company might engage two outside auditors under special circumstances (*e.g.*, merger and acquisition, initial public offering, bankruptcy, etc.), companies rarely hire one auditor for management and a different auditor for the audit committee

Other than resigning the client relationship, compensation consultants do not currently have much recourse if a company's compensation committee and management decide to act against the advice given. Furthermore, current regulations do not stipulate a process for the compensation consultant to approve or dispute what the company is disclosing in its proxy statement regarding the nature of the consulting relationship and the advice given. If the industry were to migrate toward an "audit standard," there could be an annual process for compensation consultants to review "exceptions" with the compensation committee and the company would need to make changes or be faced with a qualified opinion letter that would be included in the proxy statement.

Even without mandatory public disclosure of the compensation consultant's professional fees, it is quickly becoming "best practice" for the compensation committee to review the professional fees at the end of the year, evaluate the compensation consultant's contributions and provide direct feedback to the compensation consultant regarding any areas

of concern, including independence. This year-end review should be coupled with a meeting between the compensation consultant and the chairperson of the compensation committee at the beginning of each year to establish the work plan and key objectives for the year. This process would also help the compensation committee understand the budgetary constraints related to the use of outside advisors and prioritize their requests for compensation consulting services.

[3] Pitfalls in the Consultative Process

Notwithstanding the growing complexity of disclosure, changes in accounting for compensation and an ever-changing external landscape, much of good governance in executive compensation is rooted in good common sense. Unfortunately, sometimes things go wrong in the consultative process despite of the best intentions of all parties, even for the most experienced and talented compensation professionals. The rest of this chapter highlights potential pitfalls in the consultative process from three perspectives:

What issues do compensation consultants identify at the compensation committee level?

What specific practices are "warning signs" that there may be a problem developing?

What reasons do compensation committees and companies give when they decide to replace their compensation consultants?

[a] Issues at the Compensation Committee Level

As more and more public companies find it necessary to engage a compensation consultant, not all compensation committees understand the roles and responsibilities that consultants should be expected to accept. Although the compensation consultant is now typically interviewed by and selected by the compensation committee, the selection process is also a time when the consultant will conduct some basic due diligence before accepting the engagement. As the engagement proceeds, the compensation consultant may find that there are additional risk factors that may undermine the success of the consulting relationship. While most compensation committees work well, some warning signs at the compensation committee level that compensation consultants watch out for before accepting an engagement include the following:

The Passive Committee:

- The balance between management and the compensation committee appears heavily skewed toward management and management acts as a "gatekeeper" to the committee (less common post-Enron environment).
- The top executives are well paid and aggressive about demanding ever more pay while the compensation committee seeks to avoid conflict by conceding to management demands. In this case, the compensation committee may be hiring the consultant to play the "bad cop."

The Dysfunctional Committee:

- The committee chairperson is either too strong or too weak. Alternatively, another committee member may dominate the deliberations.
- The committee chairperson and the CEO have either too strong a personal relationship or too little shared vision and mutual trust. More than one compensation consultant has lived to tell the story of a meeting that dissolved into a shouting match between the compensation committee and management. The compensation consultant can be put into an awkward position or get sidelined by the politics. It

helps to know up front if the compensation consultant's role will be facilitator, arbitrator or referee.

- The compensation committee is "hands on" to the point of micromanagement.
- The compensation committee is so "hands off" that it even complex matters are only reviewed and determined on the basis of a one-page summary (a problem that can also occur when the committee members have too little time and/or short attention spans).
- The compensation committee adopts a "disclosure mentality" and becomes less willing to consider creative solutions that may serve the company's business needs, seeking instead program designs that most resemble those of the greatest number of peer companies. A review of "best practices" and market median pay levels should be included as part of the context for compensation decisions, but companies should avoid the growing tendency to "huddle at the median."

The Committee in Need of Insurance:

- Compensation consultants are sometimes engaged to provide a "reasonableness" opinion on specific compensation arrangements, especially as part of "expert witness" testimony in a lawsuit. These opinions are generally not sought unless the compensation levels or practices are above market (a circumstance that does not automatically mean that they are inappropriate). In this situation, the compensation consultant is clearly being retained to provide an insurance policy.

- Under more normal circumstances, compensation committees are also looking to the compensation consultant to provide a degree of comfort that the decisions they have made are appropriate. However, the compensation committee may rely too heavily on the compensation consultant. The compensation consultant is generally not in a position to evaluate an individual executive's performance and may not participate in the business planning process to the same degree as the board of directors. The compensation committee should understand that they have the ultimate responsibility for making compensation decisions. Regardless, compensation consultants are increasingly at risk for loss of reputation and even monetary penalties⁸ for "poor" compensation actions. In this regard, it has become common practice for compensation consultants to request some degree of indemnification from their clients as part of the engagement letter. In particular, the compensation consultant is at risk when its advice is contravened and it may need to document the inconsistencies between the course of action the company chooses to take and the recommendations it has made, or even resign the client engagement at the extreme.

The Neophyte Committee:

- Sometimes, a compensation committee's inexperience can become an issue in the relationship with the compensation consultant. Although the same issues may arise with experienced compensation committees, some practical day-to-day examples include:

- The compensation committee sends out a "blanket" request for proposals and interviews a multitude of consulting firms (sometimes as many as six or seven). This can be a significant waste of time and it suggests that the committee and management (a) do not know the kind of consulting relationship they want and (b) do not understand the industry.

- The compensation committee (or the company) has undervalued executive compensation expertise, with the result that the committee members and the internal human resources staff are inexperienced in these matters. The compensation consultant

will usually spend additional time on education, which may also increase the cost of the annual consulting relationship. Alternatively, the compensation committee may retain a low-cost, small compensation consulting firm for a "bare bones" assignment, which may be appropriate, as long as the potential tradeoffs compared with a "brand name" firm are understood.

- The compensation committee asks for "out-of-scope" work to be completed in a short time frame without recognizing that there will be additional costs associated with such work. The compensation consultant also has a responsibility to highlight "extra" fees.

- The compensation committee assumes that the compensation consultant will be available for all its meetings. The senior-most executive compensation consultants have become much more in demand and it is increasingly necessary to develop the committee's meeting schedule with the consultant up to a year in advance.

While the compensation consulting relationship is usually conducted with a high level of professionalism, compensation committees that suffer from one or more of these issues should understand that "it's a small world" and many senior consultants know each other.

[b] "Warning Signs"

The following list provides examples of specific compensation practices that can serve as "warning signs" to the compensation committee that there may be a problem developing. In each case, the compensation consultant should highlight the questionable practice for the compensation committee.

- The compensation peer group is considerably larger in size than or different in business mix from the company today--an "aspirational peer group." Since compensation values are typically correlated with company size, referencing a much larger peer group generally inflates the market compensation values. Frequent adjustments to the peer group may also signal a developing problem, especially when they are not related to acquisitions of existing peer companies or to changes in the company's size and business mix.
- The business plans call for significant growth, but each year the company falls short and the compensation committee is asked to consider "factors beyond management's control" and make discretionary awards. Alternatively, the compensation committee may be asked to revise the goals during the year on the basis of management's re-forecast. These may be warning signs of poor performance, an inadequate goal-setting process, miscalibration of threshold awards at levels that are inconsistent with the volatility of the performance metric, or other problems.
- The annual incentive plan has paid out at target consistently, but the long-term incentive plan has not (or vice versa). This may occur when short-term goals are adjusted to allow for significant capital investments, but the projected long-term results never materialize.
- Incentive plans based on financial targets consistently pay at or above target, but the company's stock price significantly under performs its peers. This may be a signal that the incentive plan measures are not those most closely aligned with the creation of shareholder value.
- Management proposes "special" retention awards on a regular basis. This may suggest a need to revisit the compensation program's balance between pay-for-performance and retention value.

- Similarly, when compensation programs are changed, the compensation committee may need to be wary of special awards that are needed to "make up" the difference in compensation resulting from the design changes, particularly if the "shortfall" is revisited year after year.
- Although multiple compensation survey sources are typically required to develop good marketplace consensus compensation values, the practice of hiring multiple consulting firms to answer the same data question could also indicate "data shopping"--looking for the highest set of market values.
- Frequent "compensation emergencies" that require special committee meetings (not related to unusual business circumstances like mergers and acquisitions) are generally indicative of poor planning. Similarly, the compensation committee should have ample time to review any significant changes in compensation program design or pay levels. The preference is to review proposed changes at one committee meeting and vote on the changes at the next meeting.

While this list is certainly not exhaustive, the compensation committee should expect the compensation consultant to highlight such issues, which can derail the consultative process. Depending on the relationships, it may be preferable for the compensation consultant to raise these issues in executive session, without management present. In general, it is preferable to have a short executive session at the end of each compensation committee meeting so that the compensation consultant is not put in the position of calling for a special executive session. Also, it helps if the committee chairperson is accessible to the compensation consultant in between committee meetings so that there are no surprises during meetings.

[c] Issues with the Compensation Consultant

When being considered for a new client engagement, the compensation consultant often asks the committee chairperson or management why the previous consultant is being replaced. Although few companies ever charge their former consultant with providing "bad" advice, the reasons that companies articulate can provide insights into pitfalls in the consultative process. However, it is often nothing more precise than "lack of chemistry." Here are some examples:

- It was time to get some new ideas.
- We need a more creative approach.
- The consultant recommended a new incentive plan, but it never paid out. The consultant had some great ideas, but they were not really practical for our business.
- The compensation committee selected the consultant, but the consultant and the CEO did not work well together.
- The consultant was perceived as being too close to management.
- The consultant has an independence conflict.
- The consultant was not able to guide the committee and never gave his opinion ("it depends" consulting).
- The consultant has a big personality and strong ideas that overshadowed the committee deliberations.
- The lead consultant was too busy and the project manager assigned to our case was not senior enough for our needs ("bait and switch").

- The lead consultant showed up only for committee meetings, but was otherwise difficult to reach.
- The consultant was expensive for the value we received.
- The consultant charged us for work that we did not request or authorize (in such cases, the consultant may have made a determination that the work was necessary but failed to communicate adequately with the company).
- The consultant was not strategic enough.
- The consultant made errors in data.
- Our business needs have become more sophisticated and we need a consultant who has a better handle on current trends, as well as the technical depth to support our streamlined human resources staff.
- We need a consultant who has more expertise in our industry.

Since there are at least two sides to every story, any compensation consultant who has ever been replaced could give a reason, as well. Compensation consultants often say, that if you have never been fired, you probably have not said "no" to management frequently enough. Compensation consultants may also "fire" a client, typically for non-payment, but consultants are increasingly aware of the risks of being associated with or "named" as the advisor to a company that is perceived to have excessive executive compensation. The authors of this chapter hope that, as the compensation consulting industry matures, compensation consultants and their clients will be able to improve the quality of the consultative process and avoid the many possible pitfalls discussed in this chapter.

FOOTNOTES:

(n1)Footnote 1. NYSE Listed Company Manual; 303A.00 Corporate Governance Standards; 303A.05 ("Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.").

(n2)Footnote 2. *See, e.g.*, The Time Warner Inc.'s 2007 proxy statement, showing fees paid to Towers Perrin for executive compensation consulting services versus total fees paid to Towers Perrin for consulting and actuarial services for retirement plans, consulting services on health and welfare programs provided to employees, and consulting advice on human resources systems and organizations. Some filings (*e.g.*, Conoco Phillips 2007 proxy statement) specifically noted that the companies' compensation consultants were independent and that the committees had adopted specific guidelines for the independence of compensation consultants retained to advise the committee. In addition, some companies disclosed that they have replaced their compensation consultant to ensure independence.

(n3)Footnote 3. *See* "Subpoena for Advisors on Salaries," New York Times (June 30, 2007).

(n4)Footnote 4. Executive Pay: Conflicts of Interest Among Compensation Consultants; Prepared for Chairman Henry A. Waxman by the United States House of Representatives Committee on Oversight and Government Reform Majority Staff (December 2007).

(n5)Footnote 5. For example, even if the compensation consultant provides only services to the compensation committee, the consultant's independence could be called into question if the consulting firm were to provide committee advisory services to two companies A and B, where the chairperson of the compensation committee at Company A is the chief executive officer at Company B.

(n6)Footnote 6. At the date of this writing, RMG does not have a policy regarding the independence of the compensation consultant, but this issue may well be considered by its policy group in the future.

(n7)Footnote 7. This type of fee arrangement may be negotiated in the atypical circumstance that a client company requires the compensation consultant to refrain from providing services to any industry competitors (similar to the retained executive search industry).

(n8)Footnote 8. Take, for example, the case of *The People of the State of New York against Richard A. Grasso, Kenneth G. Langone and The New York Stock Exchange Inc.*, in which Attorney General Elliot Spitzer charged that Grasso and Langone, former NYSE director and board compensation committee chair, violated their responsibilities to run the exchange in the best interests of its constituents, with respect to Grasso's compensation. As part of this lawsuit, it was alleged that Mercer, who had been the compensation consultant at the time Grasso's \$187 million compensation package was approved, provided inaccurate advice regarding the value of Grasso's SERP. As a result of these accusations, Mercer agreed to a settlement whereby it refunded \$440,275 in fees charged to the NYSE during the first eight months of 2003.



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Appendix 15-A: Business Roundtable, Executive Compensation: Principles and Commentary

2-15-A Corporate Governance: Law and Practice Appendix 15-A:.syn

§ 15-A.syn Synopsis to Appendix 15-A: Business Roundtable, Executive Compensation: Principles and Commentary

[15-A] Business Roundtable, Executive Compensation: Principles and Commentary



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Appendix 15-A: Business Roundtable, Executive Compensation: Principles and Commentary

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[15-A] Business Roundtable, Executive Compensation: Principles and Commentary *

November 2003

BUSINESS ROUNDTABLE AN ASSOCIATION OF CHIEF EXECUTIVE OFFICERS COMMITTED TO IMPROVING PUBLIC POLICY

PRINCIPLES OF EXECUTIVE COMPENSATION

1. Executive compensation should be closely aligned with the long-term interests of stockholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term stockholder value and should reflect upside potential and downside risk.
2. Compensation of the CEO and other top executives should be determined by a compensation committee composed entirely of independent directors, either as a committee or together with the other independent directors based on the committee's recommendations.
3. The compensation committee should understand all aspects of the compensation package and should review the maximum pay-out under that package, including all benefits. The compensation committee should understand the maximum pay-out under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.
4. Compensation committees should require executives to build and maintain significant continuing equity investment in the corporation.
5. The compensation committee should have independent, experienced expertise available to provide advice on new executive compensation packages or significant changes in existing packages.
6. Corporations should provide complete, accurate, understandable, and timely disclosure to stockholders concerning all significant elements of executive compensation and executive compensation practices.

EXECUTIVE COMPENSATION: COMMENTARY

FOREWORD AND INTRODUCTION

The Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in improving corporate governance practices. The Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.7 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

Compensation plays a significant role in attracting, retaining and motivating management and employees at all levels. In March 1992, when the Business Roundtable released *Executive Compensation/Share Ownership*, we noted the intense interest in compensation paid to corporate executives. The stock market boom of the late 1990's and the corporate failures of the last few years have heightened the focus on executive compensation. There has been a growing concern among investors and the public, which we share, that performance has not always been commensurate with pay, and a perception that some executives have reaped substantial financial rewards in the face of declining stock prices and staggering losses to employees and stockholders.

Compensation should serve the objectives of a corporation's business. Accordingly, the structure and components of an appropriate executive compensation program will vary widely among corporations due to such factors as a corporation's size, industry, competitive challenges, and culture. Nevertheless, the executive compensation program of every publicly owned corporation should adhere to two fundamental characteristics:

- First, it should reflect the core principle of pay for performance. While this concept is not new, it means that a corporation's executive compensation program not only rewards success, but also incorporates a meaningful element of risk.
- Second, the executive compensation program of every publicly owned corporation should be established and overseen by a committee comprised solely of independent directors. Although this often will be a compensation committee, what is important is that key executive compensation issues be addressed effectively by the independent members of the board of directors. Thus, references to the compensation committee are not intended to preclude corporations from allocating responsibility for executive compensation matters to a different committee or to the independent directors as a group.

Building on these characteristics as a foundation, the Business Roundtable has developed six interrelated principles, which are discussed in more detail in the commentary that follows, to serve as best practices for the design, implementation, and oversight of executive compensation programs at publicly held corporations.

COMMENTARY ON PRINCIPLES

1. Executive compensation should be closely aligned with the long-term interests of stockholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term stockholder value and should reflect upside potential and downside risk.

■ Compensation is a primary tool for attracting and retaining the highly qualified individuals necessary for a corporation to succeed in a competitive world economy. The board of directors is responsible for adopting and overseeing the implementation of compensation policies that support the corporation's ability to compete successfully in the marketplace.

■ Executive compensation should directly link the interests of senior management, both individually and as a team, to the long-term interests of stockholders. Equity-based compensation can be effective in accomplishing this objective.

Establishing a meaningful link between senior management and stockholder interests requires careful consideration of the incentives created by different forms of compensation.

- Compensation committees and boards of directors should establish meaningful goals for performance-based compensation; payment should be tied to the achievement of those goals. A failure to meet performance goals should eliminate or reduce payments under the award, while additional compensation should be considered where goals are substantially exceeded.
- Once performance goals are established, corporations should adhere to them. A corporation should not adjust previously established targets, or reprice options, prior to the end of a performance measurement period, or the options' term, simply because it appears that results for that period or term may fall short of the goals.
- In setting performance goals, corporations should look beyond short-term market value changes. Compensation plans should further both near-term objectives and the long-term strategic plan. They should be consistent with the culture of the corporation and the overall goal of enhancing enduring stockholder value.
- In setting performance measures, consideration should be given to a variety of performance metrics, both qualitative and quantitative. These metrics should not be tied solely to the corporation's stock price. Examples of quantitative metrics that may be used include such items as revenue and profit growth, net income, cash flow and cash management, return on equity, economic value added, cost of capital, return on invested operating capital, margins, debt reduction, cost containment, and market share. Qualitative metrics include such items as leadership, succession planning, customer satisfaction, product quality, legal compliance, ethics and the promotion of a culture of integrity at all levels of the corporation, workforce diversity and turnover, employee development, and community relations. In addition, performance relative to peer groups, as well as absolute performance, may be an appropriate measure.
- Performance-based incentives should reflect both business and individual accomplishments. Incentives should be tied not only to the corporation's operating results, but also to senior management's ability to manage the corporation effectively and create long-term value for stockholders. In this regard, performance metrics should take account of external factors, such as the impact of economic and industry trends on the corporation's business.
- A meaningful portion of executive compensation should be performance-based, thereby incorporating a greater element of downside risk into compensation arrangements. This can be accomplished, for example, by linking the granting or vesting of equity compensation to the achievement of meaningful performance targets and including a meaningful vesting period. Performance-vested stock options, performance share units, or stock appreciation rights that are payable in the corporation's stock or cash if targets are met put equity-based compensation "at risk" and link pay to performance.
- Restricted stock can be an alternative or supplement to stock options and other equity-based compensation. Although restricted stock can be an effective retention device, it is more effective as a long-term incentive if it vests based on the achievement of specified performance targets.
- Performance-based incentives will often measure accomplishments over several years. For example, in a year when the corporation experiences declining financial results, the CEO may receive performance-based compensation keyed to a previously established multi-year target. Similarly, gains realized from option exercises and stock sales in a given year may be the result of options granted over many years and several years' appreciation in the underlying stock. Corporations should take steps to enhance investor understanding of the relationship between pay and performance by providing meaningful disclosure about this relationship.

2. Compensation of the CEO and other top executives should be determined by a compensation committee composed entirely of independent directors, either as a committee or together with the other independent directors based on the

committee's recommendations.

- Directors who sit on a compensation committee should be independent in both fact and appearance. Committee members should have, and be perceived to have, the ability to exercise independent judgment free from any relationship or influence that could appear to compromise their ability to approach compensation issues decisively and independently.

- In recommending directors to serve on the compensation committee, the corporate governance/nominating committee should consider the following:

- A diversity of professional backgrounds is important to the effective functioning of a compensation committee.

- Periodic rotation of compensation committee members and the committee chair can bring fresh perspectives to the committee.

- All committee members should have sufficient knowledge of executive compensation and related issues to perform their responsibilities effectively.

- The compensation committee should assist the board of directors in carrying out its responsibilities with respect to the corporation's compensation programs. The particular duties and responsibilities that the board delegates to the compensation committee will depend on the corporation and should be set forth in a written charter.

- At a minimum, the duties and responsibilities of the compensation committee should include overseeing the corporation's overall compensation structure, policies, and programs, identifying and assessing progress with respect to performance goals and objectives relevant to the compensation of the CEO and other members of senior management, and establishing or recommending to the board all compensation for the CEO. To the extent that senior executive compensation is determined at the board level, only independent directors should participate in the approval process.

3. The compensation committee should understand all aspects of the compensation package and should review the maximum pay-out under that package, including all benefits. The compensation committee should understand the maximum pay-out under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.

- Prior to adopting or recommending an executive compensation package to the board, the compensation committee should fully understand all the benefits to the executive and the costs to the corporation of the compensation arrangement under various circumstances, including under a range of economic results and severance scenarios. The committee should know how the various elements of a compensation package, including benefits, deferred compensation arrangements, and supplemental retirement benefits, work together. Executive compensation packages should not be unduly complex.

- In structuring a compensation arrangement, consideration should be given to whether the amount and mix of compensation is reasonable, appropriate and fair in light of the roles, responsibilities and performance of the individual, the corporation's circumstances, and the need to attract and retain high quality senior executives.

- The committee should consider building into senior management compensation agreements the right to review and consider changes at appropriate time intervals. Where a compensation package is modified, the committee should assess and understand how the change will impact the overall arrangement.

- Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment. Corporations should not offer excessive severance packages that reward

executives who have not met performance goals and objectives during the term of their employment. Employment contracts, if any, should clearly articulate the consequences of termination and the circumstances in which an executive can be terminated for cause.

- Perquisites offered to executives in connection with retirement or termination of employment should be kept to a minimum, and the corporation should not bear the cost of personal expenses.

- Benefits to senior management should not be safeguarded to a greater extent than regular employee benefits.

4. Compensation committees should require executives to build and maintain significant continuing equity investment in the corporation.

- Stock ownership guidelines are increasingly being used by compensation committees to align executive compensation with the long-term interests of stockholders. The compensation committee should establish requirements that senior management, and members of the board of directors, acquire and hold a meaningful amount of the corporation's stock.

- Stock retention requirements can foster a long-term stake in the corporation among senior management. The compensation committee should consider whether to require that members of senior management hold a specified amount of the stock that they have earned through incentive-based awards for a period of time.

- To minimize questions about the propriety of particular stock trades, executives should be encouraged to consider adopting pre-arranged trading plans to the extent they determine to sell some portion of their stockholdings. Corporations may wish to make public disclosure about such trading plans when executives enter into them.

5. The compensation committee should have independent, experienced expertise available to provide advice on new executive compensation packages or significant changes in existing packages.

- The compensation committee should have the authority to retain compensation consultants, and counsel expert in compensation matters, to provide the committee with independent advice in performing its responsibilities. The committee should have the authority to select any such advisors and to approve the terms of their retention and their fees.

- The compensation committee should use information from a variety of sources in determining compensation levels. The committee should resist an over reliance on surveys and other statistical analyses in determining compensation levels. While such information can be used as a tool, company-specific factors should be given significant weight in determining executive compensation.

6. Corporations should provide complete, accurate, understandable, and timely disclosure to stockholders concerning all significant elements of executive compensation and executive compensation practices.

- Disclosure about executive compensation should be transparent and understandable to stockholders. Corporations should disclose the terms of senior executive employment arrangements each time they are entered into or materially changed. Disclosure about a corporation's executive compensation arrangements as a whole should address not only the form and amount of executive compensation (including projections of future benefits), but also the economic impact of the compensation (such as any dilution resulting from stock options) on the corporation and its stockholders, and the relationship of executive compensation packages to corporate goals and strategy.

- Corporations should use the compensation committee report included in the corporation's annual proxy statement to provide stockholders with meaningful and understandable disclosure about their executive compensation practices, the

factors that the compensation committee and the board consider in making compensation decisions, and the relationship between executive compensation and corporate performance. In fashioning this disclosure, compensation committees should furnish understandable information about the performance metrics the corporation employs.

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Appendix 15-B: NACD Annotated Glossary of Executive Compensation Terms

2-15-B Corporate Governance: Law and Practice Appendix 15-B:.syn

§ 15-B.syn Synopsis to Appendix 15-B: NACD Annotated Glossary of Executive Compensation Terms

[15-B] NACD Annotated Glossary of Executive Compensation Terms



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Appendix 15-B: NACD Annotated Glossary of Executive Compensation Terms

2-15-B Corporate Governance: Law and Practice [15-B]

[15-B] NACD Annotated Glossary of Executive Compensation Terms *

This glossary defines and discusses commonly used executive compensation terms.

Accrued compensation expense. Expense that is incurred and charged, but not yet paid (reflected on the balance sheet).

Affiliated person. An individual in a position to influence corporate policies. Includes directors, officers, 10% or more owners and families, and close associates of these groups. Also known as a "control person."

Alternative minimum tax (AMT). Federal tax on taxable income, adjusted for tax preference items. Under the Tax Reform Act of 1986 (and still in effect), paper gains in certain incentive stock options (ISOs) must be included in a separate "alternative minimum" tax calculation in the year the ISO is exercised, and the individual exercising the option must pay the greater of "regular" or "alternative minimum" tax calculated.

Annual incentive. Usually a lump-sum payment (cash, stock, etc.) made in addition to base salary for a fiscal year, based on meeting a targeted performance objective.

Attestation. An affidavit or declaration of share ownership by which an optionee exercising a stock option by a "stock swap" can avoid surrendering the actual stock certificate for the shares used to exercise the option.

Beneficial owner. Under the federal securities laws, a beneficial owner of stock is any person or entity with sole or shared power to vote or dispose of the stock. This can also include a holder who enjoys the economic benefits of ownership although the shares may be held in another name. In completing the annual director's questionnaire, directors need to disclose their beneficial ownership in any entity, including a foundation or other 501c(3) entity or trust where the director shares voting power.

Beta. A quantitative measure of the volatility of a given stock, mutual fund, or portfolio, relative to the overall market. See *volatility*.

Blackout period. A period of time prior to the release of annual or quarterly financial information by a publicly held company during which the "insiders" are restricted relative to trading the company's stock.

Black-Scholes model. One of a series of models for stock option valuation, based on an original model developed by Fisher Black and Myron Scholes in the early 1970s. In general, these models determine an up-front theoretical value of a stock option based upon its term to maturity, strike price, stock price at grant, stock volatility, dividend yield, and a risk-free interest rate appropriate for the term of the option. The valuation models differ from each other in certain assumptions, e.g., whether dividends are paid and whether the option can be exercised before its expiration date.

Bonus. An award in stock or cash made over and above base salary and incentives. Typically these are awarded annually under an annual bonus plan. Bonuses are not the same as incentives. Sometimes the terms bonus and incentives are used interchangeably to describe extra pay, but they are different. An incentive award looks forward (if you do this, we will pay this) whereas a bonus looks backward (because you did this, we are paying you this). Neither incentives nor bonuses should be guaranteed independent of performance; each must be earned.

Book-value equity incentive plan. An incentive plan that awards actual or phantom stock (either restricted or unrestricted) on the basis of its book value rather than its market value. Book value of equity is calculated as the total shareholders' equity in the company divided by the number of shares outstanding.

"Burn" rate. Stock options granted in a given year divided by the total shares outstanding, net of cancellations.

Call options. The rights to buy the corresponding stock at a fixed price until the expiration date. See also *put options*.

Capital gain (loss). Profit (or loss) from the sale of a capital asset. Capital gains may be short-term (held twelve months or less) or long-term (held more than twelve months). Capital losses are used to offset capital gains to establish a net position for tax purposes.

Carried interest. Total shares in which the owner or optionee of stock has an interest or financial stake.

Cash flow. Total funds that corporations generate internally for investment and working capital. Cash flow is often calculated as operating profits (i.e., profits before interest, taxes, depreciation, and amortization).

Cashless exercise/same day sale. A transaction in which an employee exercises a stock option and simultaneously sells some or all of the shares, with a portion of the sale proceeds delivered to the company by the broker to pay the exercise price.

Change of control (COC) provision. A contractual agreement that specifies certain guarantees to the covered employee when ownership of the company changes; typically defined to include the acquisition of a controlling percentage of the company's voting stock.

Cliff vesting. See *vesting*.

Common stock. Units of corporate ownership. Common stockholders typically vote to select the board of directors. "Preferred stock" may have more favorable dividend and liquidation rights, although more limited voting rights than common stock.

Constructive receipt. Refers to when employee compensation is taxable. The recipient has control over and access to the funds.

Deferred compensation plan. A plan that gives an individual the right to defer receipt of a payment until some stated time in the future. During the deferral period, the deferred amount may be treated as company stock, with reinvested dividends, or as cash with an interest or other carried-investment credit.

Deferred stock plan. A plan in which each participant is promised a specified amount of shares, granted at no cost if the participant remains employed with the company for a specified period of time. The participant does not have voting rights and does not receive dividends on the shares until the deferred award is actually made. Typically, the dividends accumulate during the vesting period.

Defined-benefit pension plan. A pension plan that specifies the level of benefits (or the method of determining benefits), but not the amount of company contributions. Contributions are determined actuarially on the basis of the benefits expected to become payable. In the past decade, these plans have become a minority practice, replaced by *defined-contribution pension plans*.

Defined-contribution pension plan. A pension plan that specifies the amount of company contributions, but not the level of benefits. The size of the pension is determined by how much is in the account at the time the pension becomes payable. In the past decade, these plans have become a majority practice, replacing *defined-benefit pension plans*.

Dilution. A decrease in the equity value position of company stock due to the issuance of more shares; i.e., stock options.

Discounted stock option grants. Grants with exercise prices set below the fair market value of the stock on the date of grant.

Discretionary bonus. An informal incentive award not based on a performance-related formula or specific measurable criteria.

Dividend equivalents. Rights to receive the cash dividends paid with respect to a specified number of common shares. Dividend equivalents may be paid currently, deferred, or converted into additional stock units. Dividend equivalents frequently are granted in tandem with other awards, such as performance shares or even stock options.

Employee stock ownership plan (ESOP). An employee benefit program where the company contributes a portion of its stock to an employee trust, usually as a form of profit sharing. In a matching ESOP, the employee-participant matches a contribution made by the company. Variants of such plans include the stock bonus plan and the leveraged stock bonus plan.

Employee stock purchase plan (ESPP). A broad-based employee stock plan that permits payroll deductions to acquire stock, generally at a discount. Such plans are governed under the *Internal Revenue Code Section 423*.

Employment Retirement Income Security Act of 1974 (ERISA). The law that introduced complex restrictions on pension plans. The act covers eligibility for participation, reporting and disclosure requirements, and fiduciary standards for management of retirement funds.

ERISA excess plan. A type of pension plan for key management, specifically devised to restore benefits that were reduced by the enactment of ERISA. The company makes up the difference between what an executive accrues under the company pension plan and the amount he or she is allowed to receive under ERISA restrictions.

EVA. Economic value-added, a measure of a company's return on investment that exceeds what is predicted by the capital asset pricing model.

Evergreen contract. A contract that does not expire, will be renewed, or will continue indefinitely unless one of the parties gives notice to terminate it (generally on a prospective date). These provisions are commonly incorporated in executive employment contracts. Directors should be alert to such clauses because of their long-term implications.

Evergreen stock plan. An employee stock plan in which the number of shares in the plan is increased without the need for shareholder approval, usually every year in an amount equal to a percentage of shares outstanding. Directors should make sure that such plans are in accordance with new (2002) SEC rules requiring shareholder approval of all plans that include equity.

Excess plan. A nonqualified executive pension plan designed to replace amounts generated by the underlying formulas in the general employee pension plan but capped by Internal Revenue Code provisions. Sometimes called "ERISA excess plan." See also *supplementary executive retirement plan (SERP)* .

Exercise. To buy or purchase stock options.

Exercise period. The date or dates specific stock options are available for purchase.

Exercise price. The price at which an option may be exercised. Also known as "*strike price*."

Fair value. n* The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. In terms of stock options, it usually means the stock price on the date of grant (in terms of a stock option grant made at fair market value). Quoted market prices in active markets are the best evidence of fair value and are to be used as the basis for measurement, if available. If quoted market prices are not available, the estimate of fair value is based on the best information available in the circumstances. The estimate of fair value considers prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. The Financial Accounting Standards Board requires that companies report in a footnote the fair value of options. The most recent statement on this subject is Financial Accounting Statement 148, Accounting for Stock-Based Compensation-Transition and Disclosure (from December 2002)-an amendment of FASB Statement No. 123.

Financial Accounting Standards Board (FASB). An accounting authority designated by the U.S. Securities and Exchange Commission to establish standards of financial accounting and reporting by publicly held companies.

FAS 123. Financial Accounting Standard No. 123 (FAS 123). An accounting rule that requires companies to estimate the dollar value of their stock-based compensation and either disclose the value in a financial statement footnote or, at the company's option, recognize that value as compensation expense. This rule was updated with the issuance of FAS 148.

FAS 148. Financial Accounting Standard No. 148. An accounting rule that clarifies how to apply the requirements set forth in FAS 123.

Fixed award.* An award of stock-based employee compensation for which vesting is based solely on an employee's continuing to render service to the employer for a specified period of time, that is, an award that does not specify a performance condition for vesting. Contrasts with *performance-based award*.

Flexible benefits plan. A plan under which employees can choose among a number of elective benefits (within a certain dollar amount) after subscribing to the core package of health, disability, retirement, and death benefits. Commonly referred to as "cafeteria plan."

Form 3. The initial form filed with the SEC, the issuer, and the issuer's stock exchange pursuant to Section 16(a) of the Securities Exchange Act of 1934 by all directors, officers, and holders of 10% or more of any class of equity securities

of the issuer. Form 3 details the direct and indirect holdings of the issuer's stock as well as the number of options, warrants, rights, and convertible stock or bonds. Form 3 must be filed within 10 calendar days after a person becomes a Section 16 insider, whether or not the insider owns any shares.

Form 4. Periodic form filed with the SEC, the issuer, and the issuer's stock exchange when there has been a non-exempt change in an insider's ownership of company stock such as a purchase, sale, or option exercise. Form 4 must be filed by the insider within two business days after the date the transaction took place.

Form 5. Year-end form filed with the SEC, the issuer, and the issuer's stock exchange to report certain transactions exempt from Form 4 reporting and any changes not previously reported by the insider on Form 3 or Form 4. Form 5, if required, must be filed within 45 days after the end of the issuer's fiscal year.

Form 8-K. A report required to be filed with the SEC to publicly disclose certain material corporate events such as a change in control, a significant acquisition, a bankruptcy, or a change in the company ownership.

Form 10-K. An annual report required to be filed with the SEC within 90 days after the end of the fiscal year. The 10-K includes a description of the company's business and properties, the audited financial statements, and management's discussion and analysis of the financials. The 10-K must be signed by a majority of the board of directors.

Form 10-Q. A quarterly report required to be filed with the SEC within 45 days after the end of each of the first three fiscal quarters. Form 10-Q is less comprehensive than the Form 10-K annual report and does not require that financial statements be audited. It covers the specific quarter and the year to date.

Form S-1. A "Registration Statement" (primary registration form) under the Securities Act of 1933 that a company files with the SEC to register its stock for sale. Form S-1 is generally the form used by a private company that is "going public." This is the basic, full disclosure Registration Statement. It contains the "Prospectus," along with a number of exhibits and other information about the company. The SEC staff reviews the Form S-1 and provides comments that must be resolved with the staff before the public offering can go forward. Smaller companies can use SB-1 or SB-2 in lieu of the S-1.

Form S-3. A shorter form of Registration Statement than the Form S-1 that can be used by certain already-public companies to sell additional shares. It is also the form most often used to cover resales of "restricted securities" by selling stockholders. This form permits reliance on other forms filed. It is, consequently, the easiest form to file.

Form S-4. A form of Registration Statement used when a company is issuing its shares in connection with a merger or acquisition.

Form S-8. A very brief form of Registration Statement filed with the SEC to register shares to be issued under a stock plan. This form can be used for employee plans. Does not require filing of the Prospectus.

Founders' stock. A form of stock sometimes offered to employees of new companies such as startup companies.

Golden handcuffs. An executive pay package value that could be lost upon termination.

Golden parachute. A contract between a company and one of its executives, offering the executive certain payments or guarantees of future benefits in the event of takeover. Such arrangements vary widely as to amounts and triggers. The first trigger is a change of control or hostile takeover as defined in the particular contract; a common second trigger is the termination, demotion or constructive termination of the executive. Payments in excess of certain calculated amounts can be nondeductible to the company and result in excise taxes on the recipient, as set forth in *Section 280G of*

the Internal Revenue Code.

Grant. The award of stock or an option to buy stock.

Grant date. The date on which a stock option or other similar award is effected. Awards made under a plan that is subject to shareholder approval are not deemed to be granted until that approval is obtained, unless approval is essentially a formality.

Grant price. The price an optionee must pay to exercise a market-based stock option.

Incentive stock options (ISOs). Options offered in grants that meet the requirements established by *Section 422 of the Internal Revenue Code*. For such option grants to qualify as ISOs, the optionee must be an employee, the stock option plan must be approved by shareholders, the option term cannot exceed 10 years, and the option price must be equal to or greater than 100% of fair market value at grant date. Such grants are not taxed until the stock is sold, and are not deductible as compensation expense by the corporation. ISOs are also referred to as "qualified stock options."

Indexed option plan. An option plan in which the exercise price of an at-market grant adjusts upward or downward for each period, typically a quarter, based on an external measure such as the average performance of an industry peer group. Under these plans, participants are rewarded only for above-average stock price performance.

Insider. An officer, director, or principal shareholder of a publicly owned company and members of his or her immediate family, or anyone else who possesses information that is not publicly known about the company, but which is important in valuing its stock. The most commonly recognized definition of insider in the U.S. is found in Rule 16b of the Securities and Exchange Act of 1934 (restricting the purchase and sale of stock by insiders).

Insider trading. Trading in a company's securities by company insiders or others with access to non-public information about the company. Also refers to stock tips given by or received from insiders. Insider trading is illegal under certain conditions.

Installment exercise. A stock option that can be exercised at certain times and within certain limits during its term.

Intrinsic value. n* The amount by which the market price of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of \$20 on a stock whose current market price is \$25, has an intrinsic value of \$5.

Irrevocable trust. Money held for employees that cannot be recalled by the company. One common type of irrevocable trust is called the "rabbi trust."

Long-term incentive (LTI) plan. A program providing for a payout of incentive awards based on a performance period of more than one year. Long-term incentive plans include but are not limited to stock options, stock appreciation rights, phantom stock, performance unit/share/cash plans, and restricted stock.

Measurement date.* The date at which the stock price that enters into measurement of the fair value of an award of employee stock-based compensation is fixed. It is the first date on which both the number of shares and the option or purchase price are known.

Median. The central point at which half of the data falls above and half falls below.

Mega-grants. Very large grants of stock options or restricted stock given to key executives. The purposes and conditions of these grants vary. For example, stock options may be granted at an above-market strike price, or a grant

may offset low base salary in a company with limited present ability to pay high salaries but substantial potential for improved performance and consequently higher stock price.

Milestone awards. The use of rewards for significant achievements as they occur rather than on a predetermined schedule. Rewards are given immediately after achievements and are random in that their distribution is not predictable in advance.

Named executive officers (NEOs). The five highest paid executive officers, whose prior fiscal year compensation is reflected in the summary compensation table in a public company's annual proxy statement, pursuant to SEC disclosure requirements.

Nonqualified stock options (NQSOs). Stock option grants that do not qualify for tax-favored status. The option exercise price of such awards can be set above or below 100% of fair market value at grant date and the term of such awards can be variable. Such grants are taxable to the recipient in the year the options are exercised. The option spread is deductible by companies for tax purposes, allowing the company to take the tax deduction at the time the recipient receives the option income. These options are also called "nonstatutory stock options."

Non-qualified deferred compensation plan (NQDCP). Used to postpone tax on earned income. The company's tax deduction is also postponed.

Omnibus plan. A long-term incentive plan that provides the flexibility to use a number of incentive techniques, such as stock options, stock appreciation rights, performance shares and/or units, and restricted stock.

Options. Opportunities to buy or sell under stated conditions. In executive compensation, the term options refers to stock options. Call options are opportunities to buy stock, while put options are opportunities to sell it. The following are types of stock options:

- **Accelerated ownership options (also called "incremental ownership," "reload options," and "restoration" options).** A compensation scheme in which a new option is granted for each exercise of a plan participant's stock options.
- **Exercise-hold option.** Restricted stock that is granted in proportion to shares covered or acquired by option exercise, with the lapse of restrictions contingent on retention of the shares acquired by the option exercise.
- **Restricted stock option.** An option that cannot be exercised until the end (or a period near the end) of a stated term.

Option spread. The amount by which the value of an option grant, at the time of exercise, exceeds its value at the time it was awarded; determined by multiplying the number of shares exercised by the amount by which the market price per share on the date of exercise exceeds the option's strike price per share.

Out-of-the-money. The current market price is below the stock option exercise price. When an option is out-of-the-money, it would cost more than the underlying stock is worth to exercise the option. Such options are also described as being "underwater."

Percentile. A segment of data equaling a particular percent of results. If percentiles are organized by *quartiles*, the lowest percentile shows the lowest 25%, the highest shows the highest 25%.

Performance-accelerated restricted stock award plan (PARSAP). A restricted stock award that vests eventually in

any event based on continued employment, but vesting can occur on an accelerated basis, if preset and stated objectives or performance levels are reached.

Performance-based award. n* An award based on performance, typically stock-based employee compensation for which vesting depends on both (a) an employee's rendering service to the employer for a specified period of time and (b) the achievement of a specified performance target, for example, attaining a specified growth rate in return on assets or a specified percentage increase in market share for a specified product. A performance condition might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division.

Performance share plan. A long-term incentive plan offering awards contingent upon the achievement of specified performance goals and changes in the company stock price, usually over a multi-year time period. Performance (however defined) usually determines the number of units earned; the company's ending stock price usually determines each unit's value at payout. Awards are typically settled in stock, but are sometimes payable in cash. The amount of award typically varies with performance.

Performance unit plan. A long-term incentive plan offering awards contingent upon the achievement of specified performance goals, usually over a multi-year time period. Awards are usually settled in cash, but are sometimes payable in stock. The amount of award typically varies with performance.

Perquisites. Entitlements given to selected employees, including club memberships, automobile leases, financial planning/consulting, airline club memberships, and use of company planes and automobiles. Perquisites, nicknamed "perks," can be cost-effective motivators, but they can create morale problems if they are awarded only to senior executives, especially if they are lavish. Perks are rarely if ever based on performance standards or taken away once awarded.

Phantom stock. Shares, analogous to company stock, often used by private companies or divisions of publicly traded companies. The value of phantom shares may be determined by a formula, market price, or valuation.

Premium-priced options. Options with an exercise price above the market price at the time of grant.

Put options. The right to sell the corresponding stock at a fixed price until the expiration date. See also *call options*.

Qualified stock options. See *incentive stock options*.

Quartile. A common statistical technique for displaying competitive pay data. Shows range of pay data for the 25th, 50th, and 75th percentiles, as well as the average.

Rabbi trust. A non-qualified fund for holding deferred compensation tax-free until either the company gives up the right to recall the money, the beneficiary collects, or the funds are made available to the general creditors of the company in the event of bankruptcy. Many companies have "grandfathered" certain senior executives in these types of plans, so it is important for new directors and executives not party to these arrangements to understand the meaning and implications of such instruments. See also *irrevocable trust*.

Regression. A statistical approach used to plot relations between or among data, either in a single set of factors (simple regression) or in many sets of factors (multiple regression).

Reloading options. A compensation scheme in which a new option is granted for each exercise of a plan participant's stock options. These types of awards assure that early exercise of options does not result in the termination of the total amount of options granted, since each exercised option is replaced with a new option. This form of compensation in effect eliminates the risk that the participant will not have captured the highest stock price. Every time an option is

exercised, another option replaces the exercised option, enabling the plan participant to continue to realize all the upside potential inherent in the original option grant. Reload options are also called "accelerated ownership," "incremental ownership," and "restoration" options.

Repricing options. The practice of calling in outstanding stock options that are "underwater" and reissuing a comparable or lesser number of stock options at the then-prevailing market price.

Restricted stock. A grant of stock that carries certain restrictions affecting transferability. The restrictions usually lapse over a period of three to five years, during which time the recipient cannot sell his or her shares. The recipient typically is entitled to vote the stock and receive dividends on the shares.

Return on equity. The ratio of a company's financial return to the book value of total shareholders equity. Also called "return on shareholders' equity."

Revocable trust. Money, held for a beneficiary, that a company retains the right to recall. See also *irrevocable trust*.

Rule 10b-5. An SEC rule that prohibits trading by company insiders on non-public, material information. This is also the rule under which a corporation may be sued by shareholders for false or misleading disclosure.

Section 16(a). Provision of the Securities Exchange Act of 1934 that requires company insiders to file periodic reports disclosing their holdings and changes in beneficial ownership of the company's equity securities.

Section 16b-3 Rule. A section of the Securities Exchange Act of 1934 dealing with stock transactions by corporate officers and directors ("insiders") and establishing criteria for the exemption of insider stock transactions from being considered sales/purchases for purposes of the short-swing profit recovery provision.

Section 83(b) election. A personal tax filing within thirty days of a stock grant that allows executives granted restricted stock to pay taxes on the grant date instead of on the date restrictions lapse. If an executive files the election, taxes are based on the fair market value on the grant date, with any future appreciation taxed more favorably as a capital gain. If the executive does not file an election, taxes are based on the fair market value on the date the restrictions lapse, which will be higher.

Section 162(m). The section of the Internal Revenue Code establishing tax regulations related to the \$1 million cap on deductible business expense for "non-performance-based" compensation to a publicly held corporation's named executive officers.

Section 423. The Internal Revenue Code section that regulates broad-based, all-employee stock purchase plans.

Secular trust. A fund for holding deferred compensation. Differs from a rabbi trust in that contributions are taxable to the recipient as they accumulate. Beneficiary collects when he or she retires. The assets contained within the trust are not subject to the claims of the company's general creditors in bankruptcy.

Supplementary executive retirement plan (SERP). A non-qualified method of raising pension benefits for a person who does not spend his or her entire career with a single company, either by giving credit for extra years' service or guaranteeing a specified level of pension benefits after a minimum period of service.

Short-swing trading. Trading a security within a short period of time. Section 16(b) of the securities Exchange Act of 1934 prohibits insiders from profiting by buying and selling company stock within six months or less.

Short-term incentive plan. An incentive plan under which payments are made for performance periods of one year or

less.

Spread. The difference between one value and another, as in the spread between the stock's market price and exercise price of an option. Stock options commonly are referred to as "underwater" or "in the money" depending upon the relationship between the strike price and the current market price.

Stock appreciation right (SAR). A long-term incentive technique usually used in tandem with stock options. Payouts are made in cash. SARs allow company officers to collect on the gain in option grants without regard to the six-month restriction period that normally applies under Section 16(b) of the Securities Exchange Act of 1934.

Stock options. Financial instruments, currently offered at most public companies, that give holders the right to purchase stock at a fixed price for a specified period of time. The spread, or difference between the exercise price and the market price, constitutes the reward to the option holder. Option holders usually receive no company dividends, only the difference between the exercise price and the market price. Some companies, however, adjust the exercise price for dividends or accrue dividends until the option is exercised. See also *nonqualified stock options* and *incentive stock options*.

Stock swap. Also known as a "stock-for-stock" exercise. A paper transaction form of cashless exercise transaction in which shares of company stock already owned are delivered, either physically or by "attestation," in lieu of cash to pay for the exercise of stock options.

Strike price. The price at which a stock option may be exercised. Also known as "*exercise price*."

Supplementary executive retirement plan (SERP). A nonqualified method of providing pension benefits to executives. Purposes may include the provision of one or more of the following: pension coverage of bonus amounts where the qualified plan considers only base salary, restoration of amounts which would have been payable under the qualified plan formulas except for the presence of caps (see also *excess plan*), attractive pension opportunities to an executive joining the company late in his/her career, minimum executive pensions to facilitate early retirements of executives when that is considered desirable, and/or "top hat" pension benefits due to a richer formula than that under the qualified plan.

Tandem stock appreciation rights. Rights that allow the award holder to receive a cash payment equal to the spread on a tandem stock option, in lieu of exercising the stock option. The exercise of the tandem SAR cancels the stock option.

Threshold. The part of an incentive plan formula that defines the level of performance required before payouts can occur.

Transferable stock options. Options that provide by their terms that they may be transferred by the optionee, generally only to a family member or to a trust, limited partnership, or other entity for the benefit of family members, or to a charity.

Underwater. See *spread*.

Vesting. The time when a participant's right to accrued benefits or awards (or some portion of them) becomes nonforfeitable or, in the case of stock options or stock appreciation rights, when options or rights become exercisable. Cliff vesting is the one-time accrual of all benefits once a specified amount of time has elapsed.

Volatility. A factor used in stock pricing models. Volatility measures or predicts the dispersion of stock prices over a period of time. In the Black-Scholes models, a higher volatility leads to a higher stock option value. Volatility as used in

pricing individual options considers total risk as well as systemic beta. See also *beta* and *Black-Scholes model*.

FOOTNOTES:

(n1)Footnote *. Based on definitions from the Financial Accounting Standards Board.

(n2)Footnote *. Based on definitions from the Financial Accounting Standards Board.

(n3)Footnote *. Based on definitions from the Financial Accounting Standards Board.

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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice 16.syn

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§ 16.06 Financial Crisis Legislation

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FOOTNOTES:

(n1)Footnote *. The authors gratefully acknowledge the assistance of Aaron Briggs, an associate at Gibson, Dunn & Cutcher, with the updates to this chapter.



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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice § 16.01

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§ 16.01 Evolution of Law on Executive Compensation

In its earliest stage of development, the law of executive compensation as a corporate governance issue was entirely judge-made. Some of the older cases recognized a cause of action for excessive compensation (which might be thought of, and survives, as a species of a claim for corporate waste but which, during an earlier era, seemed to take on a life of its own as a legal theory). In the last part of the twentieth century, however, the business judgment rule reigned supreme in connection with challenges to executive compensation as in other areas; courts routinely rejected "excess compensation" claims when disinterested board majorities had approved the challenged payments on adequate information and after due deliberation. More recently, in the post-Enron era, some courts, while not tampering with the fundamental elements of the business judgment rule, have given increased scrutiny to executive compensation decisions. In all events, interested-director transactions remain subject to attack as a waste of corporate assets, in some cases even where there has been shareholder ratification.

In addition, at various times, concerns over excessive executive compensation were addressed through SEC disclosure rules, tax legislation and rules, and self-regulatory organization ("SRO") rules and listing requirements.ⁿ¹ Under the current state of the law, therefore, board counselors must consider case law on executive compensation, tax rules, SEC disclosure requirements, and SRO corporate governance listing requirements. Except for the SEC disclosure requirements (which are beyond the scope of this treatise²), these are discussed, in turn, below. In addition, increasingly vocal shareholder activists and other corporate watchdogs have, in some cases, adopted executive compensation guidelines and, with increasing frequency, have made shareholder proposals on issues of executive compensation. Boards and board compensation committees need to take these trends and considerations into account, as well, in making decisions on executive compensation.

As of the date of this writing, concerns over excess executive compensation have reached a new level. Substantive legal restrictions concerning executive compensation--as opposed to disclosure requirements and tax rules on deductibility of such compensation--for the most part are a creature of state law, but recently there have been efforts to reign in excessive executive compensation through other means, including federal legislation.ⁿ³

[1] Older Cases on Reasonableness of Executive Compensation

Some older cases recognized a cause of action for "excessive compensation" or similarly styled claims under state corporate law. In some of these cases, the court simply substituted its own judgment for that of the board of directors or even stockholders in deciding that challenged compensation was "excessive" or disproportionate to the value conferred on the corporation.

For example, in *Winkelman v. General Motors Corp.*,ⁿ⁴ the plaintiffs alleged that "the defendants, beginning in 1918 and continuing to date, have been participants in a fraudulent scheme or conspiracy to loot General Motors Corporation of its assets through the payment of illegal bonuses and extra compensation."ⁿ⁵ Disinterested directors (who never received any bonuses or "extra compensation" under the plans in question, but who had approved the challenged payments) moved for summary judgment.ⁿ⁶

Despite the fact that the moving directors were independent (and were not recipients of the challenged bonus awards), and giving nodding recognition to the business judgment rule, the court nonetheless held that whether the awards the defendants had approved were reasonable and proportional to the value of the services that the recipients provided to the corporation could not be determined as a matter of law:

The main cause of complaint, for which there is some basis, is that the bonuses allotted to certain of the executives, who were also members of the Board of Directors, when added to their salaries as such executives, resulted in excessive compensation in certain years. The record contains nothing specific as to the extent and nature of their services, but it may be assumed that the duties incident to the important offices they held were such as required all the time of men of great ability.

The directors undoubtedly possessed a certain discretion in apportioning the bonus among the executives. The establishment of the various bonus plans, with the approval of the stockholders, assumed that the officers and directors charged with the duty of administering the plans would exercise a proper discretion The Finance Committee of the Board of Directors, of which the three moving defendants were at times members, considered and reported on such bonus allotments as were recommended for executives who were also members of the Board of Directors

The three moving defendants stress the fact that they did not themselves receive any part of the bonus in any year. There is no presumption of actual or constructive fraud that arises solely from the amount of compensation paid to an officer of a corporation. However, the compensation may be so large under the circumstances involved in a particular case as to constitute spoliation or waste of corporate property, in which instance an investigation in equity is warranted However, if the bonus these directors approved for any executive was so large as to constitute a waste of the corporate assets it seems to me that they are civilly liable, in a representative action by a stockholder, to the extent that the bonus was a waste--in fact a gift of corporate assets. As Judge Swan wrote in the *Rogers v. Hill* case, when it was before the Circuit Court of Appeals for this Second Circuit (*60 F.2d 109, 113*): 'If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority'. The same would seem to apply to directors, a fortiori.

I have not overlooked the rule that the exercise of business judgment by directors will not be disturbed by the courts in matters of internal management 'except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment' But if after an examination of all the facts at a trial it is shown 'that there were breaches of duty and the compensation voted in such breaches bore no relation to the services rendered,' the directors responsible for voting the compensation may be held personally liable.

... .

Although I believe in liberal compensation for the heads of large industries, I have just as firm an opinion that in bonuses and extra compensation a limit can be reached and the courts must stand ready to inquire, in the interest of the corporation, if its own executives cannot see when their bonuses have passed beyond reasonable limits.ⁿ⁷

Similarly, in *Holthusen v. Edward G. Budd Manufacturing Co.*,ⁿ⁸ a stockholder brought suit to enjoin the defendant corporation from granting stock options to executive officers and other employees. The grant was to be made pursuant to a provision of the company's by-laws, which had been adopted by a vote of the shareholders at a special meeting, authorizing the company to grant five-year options to executive officers and administrative employees, as determined by the board of directors, to purchase not more than 300,000 shares of the company's common stock at a price equal to 125 percent of the market price of the shares on the date of the grant (that is, the by-law provision authorized the board to grant only "out-of-the-money" options).ⁿ⁹

The plaintiff argued that the by-law was "illegal" and, after unsuccessfully moving for an injunction prohibiting the shareholders from voting on it, and after the shareholders adopted it by a vote of 67 percent of the outstanding shares, the plaintiff moved for an injunction to prevent the board from granting to 160 specified officers and employees options to purchase the 300,000 authorized shares. The court described the key issue as "whether the granting of these options is not a gift of the assets of the corporation or is not so out of proportion to the value of any considerations received therefore as to amount to waste of corporate property."ⁿ¹⁰

The court acknowledged the defendant's position "that the granting of the options acts as an incentive to the optionee to continue in defendant's employ, and intensifies his interest and zeal in its success" ⁿ¹¹ While recognizing that "the board of directors of the corporation should have wide discretion in determining the amount of bonuses to be granted to its employees and the terms and condition upon which they may be granted," the court nevertheless went on to state that "the amount of a bonus and the terms and conditions on which it is to be computed must have some reasonable relation to the services to be rendered" and concluded that, "[i]n the instant case, the bonuses granted have little or no relation to the services to be rendered."ⁿ¹²

The court pointed out that the recipients of the grants "undertake no obligation to continue in defendant's employ for any specified period of time ... [and that] the option, or the extent to which it may be exercised, is in no way dependent upon the actual length of future employment of the optionee." Presaging a more modern criticism of unindexed stock options, the court observed that "[i]t is the action of the stock market rather than the extent of the services rendered to the defendant which is the factor which will control the exercise of the option."ⁿ¹³ The court further stated that "[t]he argument that the services of the optionees will tend to increase the earnings of the company, and in turn the market value of the stock, ignores the numerous and extraneous factors which experience has shown motivate fluctuation of prices on the stock market" ⁿ¹⁴ The court concluded:

The grant of these options, therefore, without consideration other than the hope of retaining the donees in the employ of the defendant, is squarely within the language of Judge Swan quoted with approval by the Supreme Court in *Rogers v. Hill* ⁿ¹⁵...: 'If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority shareholders have no power to give away corporate property against the wishes of the minority.'ⁿ¹⁶

The court therefore permanently enjoined the granting of the options in question. Measured against the standards of the modern business judgment rule (under which courts decline to second-guess decisions made by disinterested directors upon adequate information and after due deliberation), the court's analysis in *Holthusen* (where the court simply substituted its own judgment for that of the company's board as to the value to the corporation of the challenged option grants) seems antiquated. By the late nineteen fifties, the precursor of the modern business judgment rule had already begun to feature in decisions on challenges to allegedly excessive compensation, with courts giving greater deference to executive-compensation-related decisions of disinterested directors and doing less second-guessing about the

"proportionality" or "reasonableness" of executive compensation.¹⁷

[2] Cases Involving Stock Option Grant Manipulation

In the early part of the new millennium, Erik Lie, an associate professor at the University of Iowa, conducted a large-scale study of stock option awards to CEOs. The data led him to conclude that it was highly improbable that the frequent extraordinary returns he observed from such option grants could be the result of chance alone, strongly suggesting that many CEO stock options had been backdated so that, in effect, they were in the money at the time of the actual grant¹⁸ (despite the misleading earlier, nominal date of the grant). In 2005, he published a paper on his study.¹⁹ Its publication created a scandal that received significant press attention and led to SEC investigations, financial statement restatements, criminal prosecutions, guilty pleas, SEC sanctions, and a wave of civil litigation.

Stock-option backdating is not illegal in itself, at least when option grants are made according to a plan that does not require options to be priced at or above the fair market value of the stock on the date of the grant. However, legal issues arise when companies conceal, fail to disclose, or misrepresent such practices. Such misrepresentations and omissions can take a variety of forms, including in connection with companies' taking advantage of accounting and tax treatments of stock options that are (or, at the time they were granted, were) legitimately available only for at-the-money or out-of-the-money options. In the wake of the Lie study and the publicity that it attracted, a raft of civil litigation over option-granting practices followed.

[a] Stock Option Claims Under the Federal Securities Laws

In *In re iBasis, Inc. Derivative Litigation*,²⁰ shareholders brought a derivative action against officers and directors in the name of a corporation that had allegedly manipulated stock option grants. The lawsuit followed an internal investigation that resulted in the company's public admission that "the appropriate measurement dates for determining the accounting treatment of certain stock option grants differ from the measurement dates used by the Company in preparing its financial statements" and a consequent restatement of previously published financial statements.²¹ The complaint alleged that options had been both backdated and "spring-loaded" (that is, issued when the company was in possession of material positive inside information). It asserted federal and state law claims for securities fraud, breach of fiduciary duties, and waste of corporate assets, among other counts. In addition, the complaint sought disgorgement of bonuses and profits under Section 304 of the Sarbanes-Oxley Act.²²

The district court dismissed the Sarbanes-Oxley claim, finding that there is no private right of action under Section 304.²³ The court dismissed the other federal claims on various grounds, including lack of causation and the expiration of the applicable limitations period, and, having done so, declined to exercise supplemental jurisdiction over the state law claims.

In *In re Openwave Systems Securities Litigation*,²⁴ the district court dismissed claims under the Securities Act of 1933 but declined to dismiss certain claims under the Securities Exchange Act of 1934 for omissions and misrepresentations in connection with defendant's backdating of stock options. Among other things, the court held that the plaintiff had adequately pleaded scienter in its claims against certain executive officers who had received backdated stock options and board compensation committee members who had granted stock options by unanimous written consent.²⁵ The court observed that the compensation committee had a duty to monitor the grant dates of options, under plans providing that options not have an exercise price less than the fair market value of the stock on the date of the grant. The compensation committee's alleged breach of that duty, the court reasoned, was sufficient to give rise to an inference of scienter, thus allowing the Exchange Act claims to survive a motion to dismiss.²⁶

In *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*,²⁷ the U.S. Supreme Court held that liability under Section 10(b) of the Securities Exchange Act of 1934 requires specific false or misleading statements or omissions attributable to each defendant. Accordingly, allegations that certain directors participated in the options backdating

scheme were not sufficient in themselves to plead liability.

[b] Stock Option Claims Under State Law

[i] Backdating Cases

In *Ryan v. Gifford*,ⁿ²⁸ a shareholder of Maxim Integrated Products, Inc. brought a derivative action against compensation committee members and other directors, alleging that they had approved option grants that were backdated to dates preceding sharp increases in the company's share price, under a plan providing that options would be granted at an exercise price at least equal to the fair market value of the company's stock on the date of the grant. Chancellor Chandler rejected the defendants' argument that the derivative suit should be dismissed for lack of a proper demand on the board, concluding that the members of the compensation committee, and the other directors to which their conduct could be imputed, faced a substantial risk of liability (and, beyond that, of further civil and even criminal liability as a result of the facts that might come out in the litigation) and, therefore, that demand would be excused under Delaware law.ⁿ²⁹

Next, the chancellor rejected the defendants' argument that the complaint failed to state a claim upon which relief could be granted because it failed to rebut the presumption under the business judgment rule that the directors were disinterested and independent:

I am convinced that the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith. Plaintiffs allege the following conduct: Maxim's directors affirmatively represented to Maxim's shareholders that the exercise price of any option grant would be no less than 100% of the fair value of the shares, measured by the market price of the shares on the date the option is granted. Maxim shareholders, possessing an absolute right to rely on those assurances when determining whether to approve the plans, in fact relied upon those representations and approved the plans. Thereafter, Maxim's directors are alleged to have deliberately attempted to circumvent their duty to price the shares at no less than market value on the option grant dates by surreptitiously changing the dates on which the options were granted. To make matters worse, the directors allegedly failed to disclose this conduct to their shareholders, instead making false representations regarding the option dates in many of their public disclosures. I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.ⁿ³⁰

In contrast, in *Desimone v. Barrows*,ⁿ³¹ Vice Chancellor Strine dismissed backdating claims in a shareholder derivative suit for, among other reasons, failure to make a demand or to allege sufficient facts to excuse demand and, as to grants made to outside directors, for failure to state a claim upon which relief could be granted. The issuer, Sycamore Networks, Inc., had "essentially admitted" in public filings that options had been backdated, and "the options were represented to the public as having been issued at fair market value, when in fact they were issued at a price lower than the fair market value that prevailed as of the dates of the Grants. In other words, the backdating was hidden."ⁿ³²

Nevertheless, noting that the "stockholder-approved option plans contemplated delegation of the option-granting function to non-director executive officers, and the complaint itself alleges that much of Sycamore's backdating operation was carried out by a single executive officer and was actively concealed from the board and from Sycamore's auditors," as to grants made to non-officer employees, Vice Chancellor Strine found that the "complaint is devoid of any

factual allegations on the key issues of who approved the Employee Grants and whether any of the directors knew that options were being backdated." Regarding those grants, the court concluded that "[t]here is simply no basis to conclude that the Sycamore board faces a substantial threat of liability" so as to excuse the plaintiff's failure to make a demand.ⁿ³³

Regarding a second category of grants, made to executive officers, the complaint alleged backdating, spring-loading and "bullet dodging" (granting options made shortly after the release of material unfavorable information). While the vice chancellor noted that, as to the officer grants, the decisions about the amounts and the recipients of the awards were less likely to have been delegated to non-director executive officers, he found no allegations in the complaint supporting an inference that "the board or even the Compensation Committee was likely to have driven details like the precise date of issuance of the Grants."ⁿ³⁴ The court acknowledged that, in a case containing allegations "creating a rational inference that the directors knowingly approved backdated grants of options, realizing that the corporation would deceptively account for them to investors and regulatory authorities as having been made at fair market value on the date of issuance, demand would be excused, consistent with the *Ryan* decision." Nevertheless, because the plaintiff had acknowledged "that he cannot even allege in good faith that the two members of the Sycamore board who served on the Compensation Committee knowingly approved improperly-backdated options, much less that the other four directors did so," Vice Chancellor Strine found that the allegations of the complaint had "failed to demonstrate that a majority of the Sycamore board faces a sufficient threat of liability over the alleged backdating of the Officer Grants to excuse demand."ⁿ³⁵

Vice Chancellor Strine also pointed out that, in contrast with the facts in *Ryan*, the stockholder-approved plan under which the Officer and Employee Grants had been made did not require that grants be made at a price equal to or in excess of the fair market price on the date of the grant; rather, it explicitly permitted the issuance of in-the-money stock options.ⁿ³⁶

As to bullet-dodging, Vice Chancellor Strine opined that such allegations are unlikely ever to support a claim for relief, other than, in extreme circumstances, a claim for corporate waste (if approved by independent and disinterested directors) or self-dealing (if approved by interested or controlled directors):

I harbor serious doubt whether any claim, other than a claim for waste, can be lodged against an issuance of options, in conformity with the terms of a stockholder-approved option plan, at a fair market value reflecting negative information previously disclosed to the public markets. In that circumstance, the only viable question would seem to be whether the grant of options was somehow inequitable, in the sense that it involved the wasteful enrichment of a recipient at the corporation's expense (when the board or committee awarding the options was independent of the recipient) or unfair self-dealing (when the awarding board or committee was controlled by those receiving the options). Although stockholders might quibble with the decision whether to give large slugs of options to officers after a disappointing quarter, no deception on the stockholders, the market, or regulatory authorities is involved and the officers have the intended incentive to perform well in order to help the corporation's stock price improve from its level on the date of issuance, a level that reflects the negative information released.ⁿ³⁷

A third category of option grants was made to Sycamore outside directors. As to the claims relating to grants to interested directors, Vice Chancellor Strine noted that demand was excused and the pivotal issue was whether the complaint stated a claim upon which relief could be granted.ⁿ³⁸ Those grants had been made under a shareholder-approved plan setting the amounts and dates of option grants to directors over a multiyear period. Because the allegations of the complaint raised no inference of manipulation or impropriety, the vice chancellor dismissed the claims relating to the Outside Director Grants for failure to plead facts upon which relief could be granted.ⁿ³⁹

Vice Chancellor Strine's opinion in *Desimone v. Barrows* contains a series of expository dicta in which the vice chancellor expounds on his views of whether directors could be held liable under Delaware law for backdating and

spring-loading, with respect to a series of hypothetical situations. It is well worth reading for those who wish to delve deeper into the nuances of developing Delaware law in this area.

[ii] Spring-Loading Cases

In *In re Tyson Foods, Inc. Consolidated Shareholder Litigation (Tyson I)*,ⁿ⁴⁰ a companion case to *Ryan* decided four months earlier than *Desimone*,ⁿ⁴¹ Chancellor Chandler had also declined to dismiss claims against board compensation committee members relating to alleged option spring-loading (the granting of options when the corporation was in possession of material undisclosed positive information). The complaint alleged that, on several occasions, the compensation committee had awarded options shortly before the corporation issued press releases containing favorable information, foreseeably leading to increases in the price of the company's stock. In discussing the spring-loading claims, the court first noted the stringent test that a plaintiff must meet to overcome the business-judgment rule in asserting claims against directors who were not financially interested in the transaction in question: "[W]here a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in *good faith* to meet their duty."ⁿ⁴²

The court went on to distinguish the "more subtle deception" involved in spring-loading from the "fundamental, incontrovertible lie" involved in backdating:

Whether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating, a practice that has attracted much journalistic, prosecutorial, and judicial thinking of late. At their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date on which the grant was actually made. Allegations of spring-loading implicate a much more subtle deception.ⁿ⁴³

In a footnote, the court drove home its observation that backdating options is inevitably improper vis-a-vis the corporation's shareholders: "Although similar to spring-loading, the backdating of options always involves a factual misrepresentation to shareholders. Issuance of options in conjunction with such deception, and against the background of a shareholder-approved stock-incentive program, amounts to a disloyal act taken in bad faith."ⁿ⁴⁴

The court observed that in spring-loading cases, the impropriety is not simply in granting an option that is, in practical effect, immediately in the money (an action that, in some circumstances, could be a legitimate exercise of business judgment) but, rather, in the accompanying deception of shareholders:

The touchstone of disloyalty or bad faith in a spring-loaded option remains deception, not simply the fact that they are (in every real sense) "in the money" at the time of issue. A board of directors might, in an exercise of good faith business judgment, determine that in the money options are an appropriate form of executive compensation. Recipients of options are generally unable to benefit financially from them until a vesting period has elapsed, and thus an option's value to an executive or employee is of less immediate value than an equivalent grant of cash. A company with a volatile share price, or one that expects that its most explosive growth is behind it, might wish to issue options with an exercise price below the current market value in order to encourage a manager to work hard in the future while at the same time providing compensation with a greater present market value. One can imagine circumstances in which such a decision, were it made honestly and disclosed in good faith, would be within the rational exercise of business judgment.ⁿ⁴⁵

The deception in a spring-loading case, the court explained, lies in taking an action that implicitly contradicts the terms of a shareholder-approved plan:

Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception. A director's duty of loyalty includes the duty to deal fairly and honestly with the

shareholders for whom he is a fiduciary. It is inconsistent with such a duty for a board of directors to ask for shareholder approval of an incentive stock option plan and then later to distribute shares to managers in such a way as to undermine the very objectives approved by shareholders. This remains true even if the board complies with the strict letter of a shareholder-approved plan as it relates to strike prices or issue dates.

The question before the Court is not, as plaintiffs suggest, whether spring-loading constitutes a form of insider trading as it would be understood under federal securities law. The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he *knows* those shares are actually worth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.ⁿ⁴⁶

The court concluded that the grant of spring-loaded options may, under certain limited circumstances, constitute a breach of fiduciary duty. Such a grant is beyond the protection of the business judgment rule if the awards are made pursuant to a shareholder-approved plan and if the directors who approved the allegedly spring-loaded grants (a) possessed material information soon to be released that would affect the company's share price and (b) issued the options intending to circumvent shareholder-approved restrictions on their exercise price.ⁿ⁴⁷

In disposing of the spring-loading allegations in *Desimone v. Barrows*,ⁿ⁴⁸ Vice Chancellor Strine distinguished *Tyson Foods I* by focusing on the differences in the directors' knowledge of and involvement in the timing of the option grants in the two cases:

The more troubling allegation, under this court's recent decision in *Tyson*, is of course that the Officers received options before a positive announcement some sixteen days later. Per *Tyson*, Desimone tries to contend that the Officers therefore received a concealed guaranteed bonus (because the granting authorities knew the market value of the corporation's shares did not reflect the positive, non-public information the corporation would soon release) rather than an award of options the value of which was dependent on the corporation's stock price increasing from a market price reflecting all material information. By sharp contrast with *Tyson*, however, Desimone does not plead facts that suggest that members of the Sycamore board approved the April 9, 2001 Officer Grants with knowledge of corporate information that, if made public on the date of the Grants, would have increased the fair market value of the corporation's stock, turning the Grants into a bonus for past performance, rather than simply an incentive for future performance. Whereas in *Tyson* the plaintiffs pled a multi-year pattern of large grants occurring at random times of year that preceded large, market-moving announcements, here all Desimone pleads is that the corporation made the April 9, 2001 Officer Grants sixteen days in advance of a non-seismic positive announcement that hardly seemed likely to send Sycamore's stock price soaring to historic heights. Nor does the complaint allege facts supporting a rational inference that the announcement of the information in fact had that effect. As important, Desimone's insinuation that the April 9, 2001 Grants were intended as a hidden bonus is undercut by the reality that the Grants were subject to a three-year vesting schedule with sharp restrictions on pledging the options received. Put simply, it is not rational to infer from the pled facts that the board harbored any illicit intent to enrich the recipients at the expense of the Sycamore stockholders or to subvert the purposes of Sycamore's stockholder-approved options plan through clever timing of these Grants. In reaching that conclusion, the fact that the two officers who sit on the board--Sycamore's CEO and its Chairman--own a combined 32% of the company and did not receive any of the disputed options tends to powerfully undercut any inference that the board itself had a motive to make its executive officers fat at the expense of the stockholders.ⁿ⁴⁹

Two months later, ruling on a subsequent motion in the *Tyson Foods* litigation, Chancellor Chandler sharpened the distinction his colleague had drawn in *Desimone*. The decision, issued August 15, 2007, denied the motion by outside director defendants for summary judgment and delivered a stinging rebuke to Tyson's board for "display[ing] and uncanny parsimony with the truth." *In re Tyson Foods, Inc. Consolidated Shareholder Derivative Litigation (Tyson II)*.ⁿ⁵⁰ Chancellor Chandler's opinion reexamines the court's earlier refusal to dismiss the claim,ⁿ⁵¹ in the clarifying light of the "more clearly delineated" allegations with respect to the current motion,ⁿ⁵² and consequently alters--and arguably broadens--the basis for allowing plaintiffs' claim to proceed.

In their motion for judgment on the pleadings, the defendants argued that the allegedly spring-loaded options were in fact "nonqualified stock options," which Tyson's Compensation Committee could make exercisable at any price, as authorized under the company's shareholder-approved stock option plan. The court accepted this assertion, finding it confirmed by a review of the stock option plan and Tyson's proxy statements, which contradicted plaintiffs' allegation that the plan required that the exercise price be no lower than the fair market value of the company's stock on the day of the grant.

This conclusion also appeared to invalidate the premise on which the court's earlier refusal to dismiss plaintiffs' allegations had been based: "that the challenged stock options may have been issued 'with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options.'" ⁿ⁵³ Rather than compel the granting of defendants' motion, however, the absence of such restrictions shifted the analysis to broader ground. The question facing the court in its earlier decision was the relatively narrow one of "whether a grant of spring-loaded options could be within the bounds of the Compensation Committee's business judgment in the face of a shareholder-approved agreement explicitly requiring a market value strike price."ⁿ⁵⁴

In light of the "more clearly delineated" allegations now before the court, however, Chancellor Chandler indicated that the test he had fashioned in *Tyson I* for determining whether spring-loading is beyond the protection of the business judgment rule may have been "couched in too limited a manner."ⁿ⁵⁵ Based on "the additional information now presented by the parties," the chancellor wrote, he was "not convinced that allegations of an implicit violation of a shareholder-approved stock incentive plan are absolutely necessary for the Court to infer that the decision to spring-load options lies beyond the bounds of business judgment." Rather, it was sufficient for the court to "reasonably infer that a board of directors later concealed the true nature of a grant of stock options" in order to "conclude that those options were not granted consistent with a fiduciary's duty of utmost loyalty."ⁿ⁵⁶

Thus *Tyson II* foregrounds the adequacy of company disclosures about the award of spring-loaded options in determining whether their authorization constituted a breach of board members' fiduciary duty to investors. In the instant case, Chancellor Chandler found, the defendants' disclosures regarding the challenged options "did nothing to rebut the pleading stage inference that the defendants intended to conceal a pattern of unfairly stocking up insiders' larders with option grants shortly before the announcement of events likely to increase the Company's stock price. In fact, the magnitude and timing of the grants, in the absence of "disclosure of the reasons motivating the grants, is suggestive ... of a purposeful subterfuge."ⁿ⁵⁷

The chancellor also insisted that the *Tyson* defendants' persistent failure to disclose the motivations for the stock option grants made the case distinguishable from *Desimone*, and his conclusions were not "inconsistent" with two of the hypothetical scenarios proffered there by Vice Chancellor Strine. Both those hypotheticals

assume that the board of directors has revealed their strategy to shareholders in complete and utter candor. In the absence of a shareholder-approved plan, the board clearly discloses in the merger proxy that these grants are rewards for exemplary service. Where the board operates under the restrictions of a shareholder-approved plan, it is explicitly assumed that "stockholders were told that the reason for [the requirement to grant stock options at market price] was singular and predicated solely on the desirability of having all grants qualify for favorable tax and accounting treatment" It is fair to say that, based

upon the actual allegations before the Court in this case, defendants' disclosures are too sparse to fit into either hypothetical analyzed by Vice Chancellor Strine in *Desimone*.n58

[3] Challenges to Stock Options Absent Manipulation of Grant Timing

In the last four decades of the 20th century, many states adopted statutes dealing with stock options, and modern cases attacking stock option plans and stock option awards often involve such statutes. For example, Delaware General Corporation Law Section 157 provides, in pertinent part:

(a) Subject to any provisions in the certificate of information, every corporation may create and issue ... rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such ... instruments as shall be approved by the board of directors.

(b) The terms upon which, including the time or times, which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options, and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. *In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive*.n59

In Delaware, the first reported decision citing this section of the law was *Michelson v. Duncan*.n60 In *Michelson*, the board of directors of Household Finance Corporation ("HFC") had, in 1966, established a stock option plan providing for stock option awards to certain key employees, including a number of the directors. Thus, this was an interested-director case in which the business judgment rule would not apply in any event. The plan was submitted to a vote of the shareholders and was overwhelmingly approved at HFC's annual meeting.

The plan that the board and the shareholders approved provided for, among other things, grants of "in-the-money" stock optionsn61 with an exercise price equal to 90 percent of the market price at the time of the grant. Initially, grants were limited to 5,000 options per year per participant, but (in an action that the plaintiff did not contest) the board later raised the limit to 15,000 options per year per participant. The options were exercisable on a defined schedule, commencing on the second anniversary of the grant, with the final 30 percent of the options exercisable on the ninth anniversary of the grant.

In 1971 and again in 1973, without a new vote of the shareholders, the board adopted a new, accelerated exercise schedule under which participants would be allowed to exercise one-third of the options on each of the second, third and fourth anniversaries of a grant, this reducing the minimum time required to exercise all options under a single grant from nine years to four years. Then, in 1974, after the market price of HFC's stock declined dramatically, the HFC board effectively repriced the original "underwater" options by allowing participants to exchange them for new options with an exercise price that was substantially below the original exercise price. At the same time, the board also issued new options at the lower exercise price.

The plaintiff brought a derivative action to challenge the changes that the board had made to the stock option plan and stock option grants between 1971 and 1974. After the litigation began, HFC asked its shareholders, at the 1977 annual meeting, to ratify the actions complained of in the derivative lawsuit. The shareholders voted to ratify the various changes to the stock option plan and stock option grants that the plaintiff had challenged, but the vote was not unanimous.

In the trial court, the vice chancellor granted defendants' motion for summary judgment on a number of grounds and denied plaintiff's cross-motion for summary judgment. On appeal, the Delaware Supreme Court held that, notwithstanding the shareholders' non-unanimous ratification of the changes the board had made in 1971 through 1974, the vice chancellor had erred in dismissing the plaintiff's claims. The plaintiff had alleged that the changes in 1974, especially the exchange of "underwater" options for "in the money" options, was wholly without consideration. The Delaware Supreme Court held that an alleged waste or gift of corporate assets with no consideration to the corporation may be ratified only by a unanimous vote of the shareholders and, under the circumstances of this case, the plaintiff's claims should not have been dismissed on a motion for summary judgment.ⁿ⁶²

As an additional argument in their defense, the defendants quoted the sentence of Delaware General Corporation Law Section 157 providing that, "In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive."ⁿ⁶³ The Delaware Supreme Court nevertheless rejected the defendants' attempted use of Section 157 in their defense, observing that the section presupposes the existence of *some* consideration, and noting that, in the case at bar, the plaintiff had alleged that the 1974 exchange of in-the-money options for "underwater" options was without any consideration to the corporation whatsoever.ⁿ⁶⁴

The Delaware stock-option statute came up again in *Byrne v. Lord*.ⁿ⁶⁵ In that case, shareholders of Pace American Group, Inc. ("Pace") challenged, among other things, in-the-money stock options that the Pace board had issued, claiming that the grant of such options constituted a waste of corporate assets. This case, too, involved an interested-director transaction, since the directors had granted the challenged options to themselves, and therefore the board was not entitled to the protection of the business judgment rule.ⁿ⁶⁶

In this context, the court set out the two requirements, under Delaware law, for the validity of a stock option plan (and awards thereunder):

First, the plan must involve an identifiable benefit to the corporation. To that end, the plan must contain conditions, or the circumstances must be such that, the corporation can reasonably expect to obtain the benefit (the 'Benefit Prong'). Second, the value of the options must bear a reasonable relationship to the value of the benefit passing to the corporation (the 'Value Prong').ⁿ⁶⁷

The court went on to observe that, under Section 157 of the Delaware General Corporation Law, if the corporation has received *some* consideration for the options, the court may presume that the consideration was adequate (and thus the 'value prong' would be satisfied), at least in a case not involving interested directors:

Delaware General Corporation Law provides some assistance to corporations in withstanding challenges under the Value Prong of the test. Section 157 states, 'in the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive' Thus, if the corporation has received some consideration in exchange for the options, then the Court may presume that the exchange is a reasonable exchange of value. However, § 157 presumes that the corporation issued the options for some consideration; its presumption would not operate if the case involved a complete lack of consideration.....One issue currently unresolved in Delaware is whether courts may give the benefit of this presumption to interested directors as well as to disinterested directors.ⁿ⁶⁸

Nevertheless, the court went on to hold that, because the board in the case before it was interested in the challenged transaction, which was not ratified by a vote of disinterested stockholders, the defendant directors had the burden of demonstrating the reasonableness of the consideration (that is, of satisfying both prongs of the test, without regard to the deference that would otherwise be accorded to their judgment under Section 157):

In a situation, as in this case, where the board of directors is interested, then the analysis turns upon whether the independent shareholders have ratified the plan. Generally, if the independent shareholders have not ratified the plan, then the interested directors have the burden of demonstrating that the plan meets the two-prong test Alternatively, if the shareholders ratify the option plan, then the challengers must show that the option plan did not represent a fair exchange of valuen69

To satisfy the benefit prong, the court explained, there must be structural features in the challenged arrangement to assure that *some* consideration will flow to the corporation:

As to the Benefit Prong, Delaware law does not require the Court to engage in a 'quid pro quo' analysis. Instead, the law recognizes that the benefits to the corporation may be intangible and may not be subject to valuation. For example, corporations may issue options for the purpose of inducing key personnel to either continue their employment with the firm or to expend greater efforts on behalf of the firm Thus, as long as the corporation expects to receive some benefit from the bargain, the key factor for the Court to consider in determining the validity of the option plan is not whether the corporation can quantify the benefit, but whether the plan itself contains safeguards or circumstances to ensure that the corporation receives the benefit for which it bargained For example, if by granting the options the corporation expects that it will retain key personnel, then the plan must provide terms, or circumstances, that ensure that the personnel are employed by the corporation when they exercise the options

... .

... Plaintiffs suggest that the plan is problematic because its terms do not require that the directors remain in office in order to exercise the options. With this allegation, Plaintiffs challenge the validity of the option plan under the Benefit Prong of the two-prong test More specifically, since the plan's stated purpose is to retain the valuable services of the directors, the Court must determine if the plan is valid because either the plan's terms or the surrounding circumstances are reasonably calculated to obtain that benefitn70

Running through the court's analysis was an undercurrent of criticism of the closed process by which the board adopted the challenged plan:

Further, I find that other facts, while not fatal to Defendants, demonstrate that the circumstances here fail to provide safeguards ensuring that Pace would receive the benefit of its bargain [I]n the current case, the shareholders did not ratify the option plan. And although shareholder ratification is not required for a court to uphold a plan, it does tip the balance in favor of upholding a plan by shifting the burden to the plan's challengers. Additionally, in this case, the board not only failed to offer the plan to the shareholders for ratification, but the board also chose not to provide any information or notification to the shareholders of the plan. Finally, the negotiations between the Pace directors who implemented the plan appear to be somewhat suspect. The board did not select an independent committee to evaluate the plan. While such an independent committee is not necessary, it would have been appropriate and helpful for the board to make some analysis as to whether the plan was adequate to achieving the benefit desired. Instead, it appears that Madero and Lord were the only directors involved in developing the plan Further, the directors never met and discussed the plan: rather, the plan was ratified by written consent by a group of directors who were beneficiaries of the plan. Thus, instead of hindsight validating the plan, the circumstances are permeated by the board's self-interest.n71

The court concluded that the plan was invalid because the director defendants had failed to meet their burden of satisfying the benefit prong of the two-prong test by demonstrating that the plan or the surrounding circumstances provided "reasonable safeguards to ensure" that the company would receive the benefit of its bargain:

... I conclude on the undisputed facts that the Defendants failed to meet the Benefit Prong of the two-prong test because neither the option plan, nor the circumstances, provided reasonable safeguards to ensure Pace would receive the benefit of its bargain Thus, the option plan is invalid as a matter of lawn72

In contrast, two years later, in *Zupnick v. Goizueta*, n73 the court dismissed a shareholder's derivative suit attacking, as corporate waste, option grants that had been approved, as a reward for past services, by the disinterested directors and by the company's shareholders. The plaintiff argued that the very fact that the options had been granted solely as compensation for past services meant that the corporation received no consideration for the option grant, which therefore constituted a waste of corporate assets. In this context (of an independent director-approved, shareholder-approved option grant), the court cited Delaware General Corporation Law Section 157 for the rule that "the judgment of the directors as to the consideration for the issuance of such ... options and the sufficiency thereof shall be conclusive."n74 In this regard, the court accepted the defendants' argument that "a disinterested board of directors may, in a good faith exercise of its business judgment, award additional retroactive compensation, i.e., a 'bonus,' to a corporate executive for extraordinary services that substantially benefited the corporation" because, among other reasons, doing so can induce "other key employees to remain in the corporation's service and to perform at a high level, motivated by the prospect that at a future time they too might be similarly rewarded."n75

[4] Application of Business Judgment Rule in Executive Compensation Cases

As early as the late nineteen-fifties, courts began giving greater deference to the executive compensation decisions of disinterested directors, rather than substituting their own judgment for the judgment of such directors on the "reasonableness" or "proportionality" of challenged compensation awards. For example, in *Lieberman v. Becker*,n76 the plaintiff sought a judicial declaration partially invalidating a so-called Deferred Compensation Unit Plan for corporate executives and employees after the plan had been approved by a vote of the shareholders of Koppers Company and a committee of disinterested directors (each of whom was ineligible to participate in the plan) had been created to award units under the plan. The plan was akin to a "phantom share" plan.n77 Units awarded were credited with an amount equal to dividends paid on Koppers' common stock during the period from the award through the termination of each participant's employment with Koppers. In addition, the units were credited with an amount equal to the market appreciation of Koppers' common stock during the same period (subject to a participant's ability to elect to fix the "ending" market price as of the date of termination of employment or as of any date within three years after termination of employment, provided that, in no case, could the ending market price exceed the highest market price of Koppers' common stock between the date of the grant and the date of termination of employment).

To be eligible (or for his or her beneficiary to be eligible) for the cash payout, the participant's employment with Koppers must have terminated by reason of death, retirement or disability. The total of the dividend credit plus the market-appreciation credit would then be paid out, in quarterly installments, to the participant (or beneficiary) over a ten-year period following the participant's termination of employment. In exchange for becoming eligible to participate in the Deferred Compensation Unit Plan, a participant would be required to agree to remain in Koppers' employment for a period of five years, or until retirement; to be available as a consultant for 10 years after retirement; and not to compete with Koppers or become an employee of any competitor of Koppers.n78

In the trial court, the vice chancellor granted summary judgment to the defendants, "ruling that the Deferred Compensation Unit Plan is reasonably designed to achieve a legitimate business purpose--that of retaining qualified executive personnel in the employ of Koppers."n79 On appeal, the Delaware Supreme Court initially noted and applied "two fundamental rules of law as to which there can be no argument":

The first rule is that a plan for additional compensation of executives and employees is to be held valid only if consideration passes to the corporation at the time the plan is put into effect.....

The second rule is that there must be a reasonable relations [sic] between the value of the benefit conferred by the plan upon the employee and the value to the corporation of the employee's service to it ... n80

The court noted that there could be "no doubt" that the first rule (consideration to the corporation) was satisfied by the requirement that the participant make certain promises, for the benefit of the corporation, at the time of the award. The court then proceeded to consider what it characterized as "the main thrust of the plaintiffs argument[:] ... that there is no reasonable relationship between the value of the benefits conferred upon the employee by the plan and the value of his services to the company."n81

The court characterized the plaintiff's attack as being that "the market value of the common stock is too speculative an element to form a reasonable basis for determining executive compensation," citing the plaintiffs' own argument that "the market appreciation factor of the Koppers' phantom stock plan ... is tied to the vagaries of the stock market" and "[t]here is therefore no reasonable relationship between compensation so computed and the value of the services thus compensated, unless by chance."n82 The court then mentioned a "variety of factors" that the plaintiff had cited as determining the market price of common stock, "including interest rate on money, corporate earnings, the business cycle, commodity prices, the psychology of the buying public, labor relationship, and others," leading the plaintiff to conclude that, thus, "the employee's services do not necessarily have any direct relation to the fixation of the market price of the securities of the corporation for which he works."n83

In resolving this element of the dispute, the court foreshadowed the modern business judgment rule by giving substantial deference to the committee of disinterested directors charged with the responsibility of awarding units under the plan:

We must assume that the committee of directors charged with the administration of this plan will do so in the good faith exercise of their considered business judgment. Indeed, there is no charge that they have done otherwise. Certainly, therefore, assignments of units will be made on the basis of the committee's judgment of the worth of the employee's services to the company, his length of service and contribution in the past and to be expected in the future to the company's prosperity, and numerous other factors, not the least of which should be their best guess of the future prospects of the company's stock on the open market. A decision by responsible businessmen reached after careful consideration of these factors, without bad faith or fraud, is entitled to weighty consideration by the courts.n84

The court concluded that, "whether or not a corporation should embark upon such a method of compensating its employees is to be decided by the board of directors by the exercise of their business judgment. When a corporate decision is made in the light of the best business judgment of its management, absent fraud or bad faith, the courts do not interfere."n85

Beard v. Elster n86 was a Delaware Supreme Court decision on the validity of a stock option plan. While the decision was handed down before the adoption of Section 157 of the Delaware General Corporation Law,n87 it is instructive in that it emphasizes the importance of deferring to the judgment of disinterested directors in matters of executive compensation. The case was a stockholders' derivative action challenging grants of stock options under a plan adopted by American Airlines, Inc. after the approval of (a) the company's board of directors consisting of 14 disinterested directors and two other directors who ultimately received option grants under the plan, and (b) the company's shareholders. In reversing a decision of the Court of Chancery denying the defendants' motion for summary judgment, the court distinguished earlier Delaware cases, in which option plans had not been approved by a disinterested board, and emphasized the significance of the approval of the challenged plan by a disinterested board in the case before it:

The option plan now before us was adopted initially by an admittedly independent and disinterested Board of Directors.

... .

Of prima [sic] importance is the fact that the adoption of the plan by the Directors was an exercise of independent business judgment that the plan would be of benefit to the corporation and would result in the retention of the services of valued employees

... .

We think the fact that a disinterested Board of Directors reached this decision by the exercise of its business judgment is entitled to the utmost consideration by the courts in passing upon the results of that decision

We have before us a plan which, in the judgment of a disinterested Board, is adequately designed to further the corporate purpose of securing the retention of key employees' services. It is theoretically possible, we suppose, that some businessmen could be found who would hold the opinion that options exercisable at once were improvidently granted, but, on the other hand, there are businessmen who would hold a favorable view, as this Board of independent businessmen in fact did. At most, therefore, we find ourselves in the twilight zone where reasonable businessmen, fully informed, might differ. We think, therefore, we are precluded from substituting our uninformed opinion for that of experienced business managers of a corporation who have no personal interest in the outcome, and whose sole interest is the furtherance of the corporate enterprise.ⁿ⁸⁸

The business judgment rule has also been applied to insulate stock option repricing from second-guessing by shareholder plaintiffs and the courts. *Cohen v. Ayers* ⁿ⁸⁹ was a shareholder's derivative action attacking several actions of the board of directors of Sears, Roebuck & Co. in connection with the company's stock option plan. The plan at issue was originally recommended by the company's board of directors and approved by the company's shareholders in 1967. The plan was to be administered by a committee of non-employee, disinterested directors. The exercise price of options under the plan was to be set at the fair market value on the date of the grant.

In 1973 and 1974, the price of the company's stock declined and options previously granted under the plan became exercisable at a price in excess of the price at which the shares were then trading (*i.e.*, the options were "underwater"). In response to this situation, in early 1974, the Committee resolved that outstanding options would be canceled and that an equivalent number of new options would be granted with exercises prices set at the then-fair-market value of the company's stock. As the company's stock continued to decline in price, the Committee repeated the process (of canceling old, "underwater" options and issuing new at-the-money options in their place) later that year.

The plaintiff brought a shareholder's derivative action challenging the cancellation and reissuance of options (essentially amounting to a repricing of outstanding options) on several grounds, including the ground that the board's actions amounted to a waste of corporate assets. After the suit was brought, the board called a special meeting of shareholders and distributed proxy materials recommending that the shareholders ratify the challenged actions of the board (in canceling and re-granting options). The shareholders passed the resolution in 1976 by an overwhelming majority.

The defendants moved for summary judgment, which the district court granted, and the plaintiff appealed. The Court of Appeals affirmed the judgment below. The court rejected the plaintiff's waste argument, finding that the challenged actions were protected by the business judgment rule, in this case because of the shareholder ratification, but also noting that the business judgment rule would apply in cases where the challenged actions were taken or approved by a majority of disinterested directors:

The plaintiff also charges that the option reissues constituted waste and a gift of corporate assets. The following general principles of law are applicable in deciding issues of waste or corporate gifts. Ordinarily, employee compensation and other corporate payments are not a waste or gift of assets as long

as fair consideration is returned to the corporation. The question of the adequacy of consideration is committed to the sound business judgment of the corporation's directors However, where the directors have a personal interest in the application of the corporate payments, such as where they are fixing their own compensation, the business judgment rule no longer applies and the burden shifts to the directors to demonstrate affirmatively that the transactions were engaged in with good faith and were fair, i.e., that adequate consideration had been supplied. This alternation in the burden and quantum of proof may only be avoided in two circumstances: after full disclosure the payments must have been ratified either by action of disinterested directors or by vote of the shareholders. If the payments are thus ratified, then the business judgment rule is again applicable and the plaintiff can succeed only by meeting the burden applicable to challenges of any corporate transaction.ⁿ⁹⁰

While *Cohen* is still good law, as a matter of best practice recommendations and in accordance with the positions taken by influential institutional investors and proxy advisory services, options repricing today is widely frowned upon; it is unlikely that companies will want to adopt plans that permit repricing of underwater stock options.

The business judgment rule also has been applied to protect directors' decision to award certain benefits shortly before the commencement of negotiations leading to a change in control.ⁿ⁹¹ *National Insurance Co. v. Johns* ⁿ⁹² involved claims for payment under a directors' and officers' liability policy following the settlement of a shareholder's derivative suit. One of the claims in the underlying case was that the directors of Southwest Bank had wasted the corporation's assets and had exceeded their authority and breached their fiduciary duties by, among other things, adopting a Performance Incentive Plan under which units could be awarded by the chairman of the board of directors upon the recommendation of a committee of three directors, except in the case of awards to the chairman himself, which could be made only by the committee. The holders of the units would be paid \$10 per unit upon the earlier of (a) the fifth anniversary of the award, or (b) a change in control of the company.

At the time the board adopted the plan, there was no agreement that would result in a change of control of Southwest, although management knew at that time that the company "had become an attractive takeover target and that someone could acquire a controlling block of Southwest's stock by an unfriendly tender offer."ⁿ⁹³ Units were awarded to a number of senior executives, including the company's chairman and two other directors (a total of three inside directors out of 15 directors in total) who had voted to adopt the plan.

Several months later, the board of Southwest approved a merger that would result in a change in control, thus triggering payments under the plan in question. A Southwest shareholder filed a derivative action attacking the awards under the plan--as well as the company's agreement to pay its chairman under a five-year consulting agreement that the board had approved concurrently with its approval of the merger--as a waste of corporate assets.

After the case was settled, the D&O insurer resisted reimbursement under the policy on the ground, among others, that the insurer's had no obligation under the circumstances because of a coverage exclusion for:

any payment for loss in connection with any claim made against the Insureds ... for the return by the Insureds of any remuneration paid to the Insureds without the previous approval of the stockholders of the Company which payment without such previous approval shall be held by the courts to have been illegal.ⁿ⁹⁴

The court began its analysis of this issue (the legality of the payments) by observing that "Florida corporations are expressly granted the power, through the acts of their boards of directors, to fix compensation for their directors and officers, including the adoption of incentive and other compensation plans."ⁿ⁹⁵ Because, in addition, the company's by-laws and charter did not require shareholder approval for the adoption of such plans or the determination of the compensation of directors and officers, the court found that the directors (a majority of whom were disinterested) had properly adopted the challenged plan.ⁿ⁹⁶

The court then proceeded to analyze the insurer's argument that it was not required to pay the claim under the policy because of another exclusion, providing that:

[the] insurer is not liable to make any payment in connection with any claim made against the Insured based upon or attributable to their gaining in fact any personal profit or advantage to which they were not legally entitled.ⁿ⁹⁷

To determine the applicability of this exclusion, the court turned to the plaintiff's argument that the challenged plan and agreement constituted a waste of corporate assets (and therefore, at least as to those directors who profited from the plan and the agreement, a source of "personal profit or advantage to which they were not legally entitled").ⁿ⁹⁸ Addressing what it referred to as a "case of first impression," the court restated the issue as "whether the implementation of a 'golden parachute' agreement by a disinterested board of directors may be found to be a breach of their fiduciary duty to the corporation; or whether the adoption of the Plan and Agreement are protected from judicial interference by the business judgment rule" and concluded that "the conduct of the Defendants fell within the proper scope of their authority and responsibility ...".ⁿ⁹⁹ The court held that the plaintiff had failed to establish "that the amount in controversy represents an unreasonable compensation for the services of these Defendants, such that we should not defer to the business judgment of Southwest's Board."ⁿ¹⁰⁰

In 2006, the Delaware Supreme Court sounded a resounding note for the continuing vitality of the business judgment rule in cases involving challenges to executive compensation. *In re Walt Disney Derivative Litigation* was a shareholders' derivative action against the directors of The Walt Disney Company for breach of fiduciary duties, waste of corporate assets and other claims challenging the board's decisions (1) to approve the hiring of Michael Ovitz as president of the company under a contract providing severance terms that turned out to be extremely lucrative (as well as other terms and conditions that the plaintiffs criticized as being inimical to the company's best interests), and (2) later (after the board was reconstituted) to authorize a "no-fault" termination of Ovitz's employment, triggering total severance payments amounting to over \$140 million (including gains on stock options). The substantive decisions of the Delaware Chancery Court and Delaware Supreme Court in the Disney case are discussed at length in section 10.03 of Chapter 10 of this treatise. In its final decision in the case (referred to in this treatise as Disney IV), the Delaware Supreme Court upheld the decision of the Chancery Court that the challenged actions were protected by the Delaware business judgment rule, even though the processes of the Disney board and its compensation committee fell short of recognized "best practices" for approval of executive compensation.ⁿ¹⁰¹

Thus, the business judgment rule has been successfully used to defend a variety of executive compensation actions taken by disinterested directors on adequate information and after due deliberation. In cases where the board is approving compensation plans or actions for executives only, and not for the directors themselves, the board's advisors can go a long way toward protecting the board's actions from attack by ensuring that the directors follow a careful, thorough process so that there can be no legitimate question that they have discharged their duties of care and loyalty and that their decision is therefore entitled to the protection of the business judgment rule. The process should include:

- the provision to the board of adequate information, sufficiently in advance of each meeting to allow the directors to read and fully digest any materials relating to the issues under consideration;
- the retention, when appropriate, directly by the board or board committee of independent outside experts (including independent counsel when necessary);
- the allowance of ample time and an adequate number of meetings to permit the directors to explore and understand fully all aspects of the compensation plan or action under consideration, including its potential total cost to the corporation and the value of the total payments and benefits payable to each executive;

- the avoidance of undue influence on the work of the committee or the board by any company executive, including the CEO or those (such as the director of human resources or company-retained counsel or consultants) who report to the company's executives; and
- a vigorous open debate and discussion on the part of independent directors before they make a decision on the approval of the proposed plan or compensation action before them.

[5] Board's Business Judgment Not Entitled to Deference When Directors Are Not Independent

Nevertheless, even under the traditional Delaware business judgment rule, when a defendant cannot satisfy the prerequisites of establishing that an independent and disinterested board acted in good faith and with due care in connection with a compensation decision, the court will not defer to the decision of the directors but, instead, will review the challenged action *ab initio* under the entire fairness doctrine. In *In re Viacom Inc. Shareholders' Litigation* n102, the court considered a motion to dismiss a shareholders' derivative action seeking, among other things, to recover compensation allegedly wrongfully paid to senior executive officers of Viacom Inc. (including \$159,996,504 paid in one year to Viacom's COOs and CEO). Plaintiffs claimed that the compensation paid was excessive and was awarded at a time when Viacom was experiencing significant losses. Defendants moved to dismiss the complaint on the basis of the business judgment rule, arguing that the actions in question had been taken by independent and disinterested directors on adequate information and after due deliberation.

To rebut the business-judgment-rule defense, plaintiffs argued that the directors in question were not independent. Because the defendants had acknowledged the lack of independence of several of the directors, to rebut the application of the business judgment rule the plaintiffs had only to persuade the court that one additional director was not independent. To do so, they argued, and the court accepted, that one of the directors, Alan Greenberg, lacked independence because of his long-standing business and personal ties to Viacom's CEO, Sumner Redstone. Among other things, Greenberg had been Redstone's investment banker and, in that capacity, had advised Redstone in his 1993 acquisition of Paramount Communications and his 1994 acquisition of Blockbuster Inc. Greenberg, as well as his employer, Bear Stearns, had also advised Redstone in connection with the 1994 unwinding of the Blockbuster acquisition and had allegedly continued to provide other broker and advisory services to Redstone. On these facts, the court found that there was "a reasonable doubt as to his ability to evaluate plaintiffs' demand [that Viacom pursue recovery of amounts allegedly wrongfully paid to Redstone and other senior executives] without a taint of interest, 'extraneous considerations' or influences."n103

Accordingly, the court held that the plaintiffs' claim that the directors had breached their fiduciary duties in approving the challenged compensation would not be dismissed on motion, and that it would apply the "entire fairness" test in assessing whether to uphold the Board's decision to award the challenged compensation.n104

Similarly, in *California Public Employees' Retirement System v. Coulter*,n105 plaintiff shareholder California Employees' Retirement System ("CALPERS") brought a putative class action and shareholders' derivative suit against Lone Star Steakhouse & Saloon, Inc. ("Lone Star") and several of its officers and directors, attacking repricing of options, certain related transactions and severance contracts for key executives. Lone Star moved to dismiss for the plaintiff's failure to make a pre-suit demand or to plead facts sufficient to show that such a demand should be excused for the derivative claims.

The complaint included particularized allegations that, on their face, painted a credible picture of manager and director entrenchment. After CALPERS had already made known its dissatisfaction with Lone Star's management and had successfully submitted a proposal to Lone Star's shareholders to amend the company's by-laws to require that the Lone Star board consist of a majority of independent directors, and after the Council of Institutional Investors had proposed a board resolution to the same effect and to declassify the Lone Star board, the Lone Star board adopted change-in-control

agreements for several senior executives.

CALPERS alleged that, as originally adopted, the agreements would have triggered payments to departing executives upon a change in control in an amount that could have exceeded one-third of the company's market capitalization (on certain assumptions). Later "clarification of how the agreements would operate reduced that amount to approximately one-eighth of Lone Star's market capitalization - still a significant portion of the company's value."ⁿ¹⁰⁶ As is standard in change-in-control agreements, a change of control was defined to include a turnover in a majority of the sitting directors without their approval.

In these circumstances, in ruling on the necessity of pre-suit demand, the court found that the provision in the change-of-control agreements concerning the failure to re-elect a majority of the board--when the board had allegedly approved those contracts in the face of a perceived threat to the incumbent directors' positions and with the intention of entrenching those directors in office--raised a presumption that they were "interested" in the change of control contracts (despite the fact that they would not benefit directly from the change of control payments) and, thus, raised a reasonable doubt about their ability to consider a demand to initiate litigation on a disinterested basis.ⁿ¹⁰⁷ In addition, in finding that one director could not be presumed to be disinterested, the court noted his "lifelong friendship" with the company's CEO and the fact that the director's son was employed by a company subsidiary, among other factors.ⁿ¹⁰⁸ Under these circumstances, the court found that the challenged transactions had not been approved by a disinterested board whose decisions were entitled to the protection to the business judgment rule and, therefore, that pre-suit demand was excused.ⁿ¹⁰⁹ In addition, in reviewing whether the directors had discharged their duty of care in approving the challenged transactions, that court found that an allegation that "the only document in Lone Star's corporate records related to ... [one of the challenged option repricing] transaction[s] is the signed resolution of the Stock Option Committee implementing the repricing ... could indicate that the Stock Option Committee failed to exercise business judgment when repricing employee options"n110

Although *Coulter* was largely an entrenchment case, and one that involved seemingly egregious facts, it does represent a post-Enron court's refusal to apply the business judgment rule because of, among other things, factors that courts had often previously deemed to be insufficient to overcome the presumption of director independence. Such factors included as personal friendships, employment of a family member, and the inclusion of a rather standard provision in a change-of-control contract that could, in the circumstances of that case, have had an entrenching effect and which may have been adopted with the purpose of director entrenchment.n111

[6] Continuing Viability of the Doctrine of Corporate Waste in Interested Director Cases, Even Where There Has Been Shareholder Ratification

Even in the 1980s and 1990s, as courts gave more deference to the business judgment of independent and disinterested directors, they continued to allow challenges to compensation decisions as wastes of corporate assets even, in some cases, in the face of shareholder ratification. The business judgment rule does not protect directors from challenges to interested-director transactions where there has been no shareholder ratification. Furthermore, even when there has been shareholder ratification, the corporate waste theory remains viable when the directors have authorized an expenditure of corporate funds that no reasonable person could find to have a legitimate corporate purpose.

*Stein v. Orloff*ⁿ¹¹² was a shareholder's derivative action challenging a number of transactions involving Evans Products Company and senior executives of Sharon Steel Corporation, a company that acquired Evans Products, including Victor Posner (who was chairman of the board, president or CEO of Sharon Steel and a number of related corporations and later became CEO of Evans Products) and Monford Orloff (the Chairman of the Board of Evans Products at the time of the allegedly wrongful acts).

Among other things, six directors of Evans Products were granted five-year employment contracts and another director's existing employment contract was amended, in each case providing for severance payments in the event of a merger or

other specified transactions, including a reduction of the then-current board membership to less than 60 percent of the total sitting directors. Two days later, Evans Products entered into an agreement in principle to merge into Sharon Steel. The complaint alleged that the employment agreements were designed so that the benefits would automatically be triggered upon the occurrence of the allegedly then-foreseeable merger.¹¹³ On April 20, 1983, after the merger failed (for a reason not explained in the opinion), the Evans Products board met and took several actions, which the complaint portrayed as an orchestrated series of events designed to enrich the senior executives Victor Posner, his son Stephen Posner, and Mr. Orloff:

The Board of Directors expanded its number from 14 to 16. Three members of the Board resigned and two days later a fourth resigned, while four new members were elected (including Mr. Posner and his son, Stephen Posner). Mr. Orloff then resigned as Chairman of the Board in favor of Mr. Posner, and Stephen Posner was appointed Vice Chairman. Mr. Orloff, Mr. Posner and Stephen Posner were then appointed as the three members of the Evans Products Company's Executive Committee. A Board composed of 16 directors was elected at a shareholders' meeting on June 8, 1983. The Complaint alleged that Mr. Posner designated eight of the members and that Mr. Orloff designated the other eight members. The Complaint alleges that as an inducement to Mr. Orloff to allow the changes on Evans Products Company's Board, he was elected to the Boards of both Sharon and NVF [another Posner-controlled company] and as President, Chief Executive Officer and member of the board of DWG [yet another Posner-controlled company]. He was given a five-year employment contract with DWG for \$360,000 per year. This contract is alleged to be a sham and allegedly intended as 'payment for the sale of offices and directorships which are assets belonging exclusively to Evans Products Company.'¹¹⁴

In an analysis that contrasts sharply with the approach of later Delaware cases,¹¹⁵ the Vice Chancellor concluded that allegations of extensive business relationships between the various directors and Mr. Posner were "insufficient to demonstrate a reasonable doubt that the directors were independent or disinterested" for purposes of impartially entertaining a pre-suit demand in the sound exercise of their business judgment.¹¹⁶ The court also found that "no facts are alleged in the Complaint which would give rise to a reasonable doubt that the Board members had acted in such a grossly negligent manner in approving the challenged transactions as to deny themselves the protection of the business judgment rule."¹¹⁷

Nevertheless, the court held that the complaint set forth sufficient allegations of corporate waste to withstand a motion to dismiss the waste claims. The waste claims involved downward repricing of "underwater" stock options in January of 1983. Although not explicitly pointed out in the opinion, it can be deduced from the facts stated that, at the time of the repricing, seven of the 14 then-sitting directors held more than three-quarters of the options that were the subject of the repricing.¹¹⁸ The court held that the allegations of the complaint concerning the repricing were sufficient to support the claim for waste of corporate assets:

It is alleged that the reduction in option price was given without consideration and constituted a waste of corporate assets

The test for finding a waste of corporate assets is whether the consideration received by the corporation was so inadequate that no person of ordinary, sound business judgment would deem it worth that which the corporation paid The Complaint alleges pre-existing options on which the option price was reduced without any consideration being received for the reduction. This is a sufficient allegation of facts to state a claim for waste and therefore to create a reasonable doubt that the transaction was the result of a valid exercise of business judgment.¹¹⁹

The *Orloff* decision shows just how far the Delaware Chancery Court had gone by the mid 1980s in upholding allegedly abusive executive contracts and compensation practices (a trend that has decidedly reversed itself in more recent years¹²⁰). Nevertheless, at least in the case of an interested-director transaction that enriched directors with no

consideration flowing to the corporation and no shareholder ratification, it also showed that, even at that time, Delaware courts continued to recognize a cause of action for waste of corporate assets.

By the middle of the 1990s, in a thorough and scholarly analysis of the state of the Delaware law on the waste doctrine, Chancellor Allen held that, even when there has been subsequent shareholder ratification, allegations of directors' self-dealing may be sufficient to state a cause of action for waste of corporate assets that will survive a motion to dismiss. In *Lewis v. Vogelstein*,ⁿ¹²¹ a shareholder of Mattel, Inc. challenged a stock option compensation plan for directors, which had been approved by the company's shareholders at its 1996 annual meeting. The plaintiff argued, among other things, that the grant of options made under the 1996 plan "did not offer reasonable assurance to the corporation that it would receive adequate value in exchange for such grants, and that such grants represent excessively large compensation for the directors in relation to the value of their service to Mattel Plaintiff maintains that because the Plan constitutes a self-interested transaction by incumbent directors, all of whom qualify for grants under the 1996 Plan, they must justify it as entirely fair in order to avoid liability for breach of loyalty, which it is said they cannot do."ⁿ¹²²

After rejecting challenges to the adequacy of the company's disclosures to the shareholders in connection with the ratification of the 1996 Plan, Chancellor Allen turned to the allegation that the adoption of the 1996 Plan or the making of grants thereunder constituted a breach of the directors' fiduciary duty of loyalty. In this vein, the court began with the observation that, "[a]s the Plan contemplates grants to the directors that approved the Plan and who recommended it to the shareholders ... it constitutes self-dealing that would ordinarily require that the directors prove that the grants involved were, in the circumstances, entirely fair to the corporation."ⁿ¹²³ Further, because he had rejected the plaintiff's claims concerning the adequacy of the corporation's disclosures to the shareholders in seeking ratification of the 1996 plan, Chancellor Allen said that, for purposes of the analysis of the claims for breach of fiduciary duty, he would assume that the ratification was effective, raising the question of the effect of informed shareholder ratification on "a transaction of this type (*i.e.*, officer or director pay)."ⁿ¹²⁴

After going through a comprehensive discussion of the Delaware law concerning shareholder ratification, Chancellor Allen concluded "that, in addition to a claim that ratification was defective because of incomplete information or coercion, shareholder ratification is subject to a claim by a member of the class (of shareholders) that the ratification is ineffectual ... because the transaction that is ratified constituted a corporate waste."ⁿ¹²⁵

Having come to the conclusion that self-interested director transactions could be attacked, even after informed shareholder ratification, on the ground of waste, Chancellor Allen then reviewed the stringent standard under Delaware law for determining what constitutes a waste of corporate assets:

Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade ... Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky.ⁿ¹²⁶

Chancellor Allen then reviewed the early Delaware cases on this point, coming to the conclusion that--because of the Delaware courts' "skeptical or suspicious stance toward the innovation of stock option compensation as it developed in a major way following World War II," a stance he described as a "fairly natural consequence of the common law of director compensation and of the experience that corporate law judges had over the decades with schemes to water stock or to divert investors [sic] funds into the hands of promoters or management"ⁿ¹²⁷-- while nominally invoking the "waste" doctrine, "the waste standard used by the courts [in the early cases] in fact was not a waste standard at all, but was a form of 'reasonableness' or proportionality review."ⁿ¹²⁸ Chancellor Allen expanded on this point:

This (1) weighing of the reasonableness of the relationship between the value of the consideration flowing both ways and (2) evaluating the sufficiency of the circumstances to insure receipt of the benefit sought, seem rather distant from the substance of a waste standard of judicial review. Indeed these tests seem to be a form of heightened scrutiny that is now sometimes referred to as an intermediate or proportionality review.ⁿ¹²⁹

Chancellor Allen went on to discuss the influence of the Delaware Supreme Court's 1960 decision in *Beard v. Elster*ⁿ¹³⁰ on how the Delaware courts treated challenges to self-dealing transactions on the part of corporate officers and directors:

After *Beard*, judicial review of officer and director option grants sensibly focused in practice less on attempting independently to assess whether the corporation in fact would receive proportionate value, and more on the procedures used to authorize and ratify such grants. But *Beard* addressed only a situation in which an independent committee of the board functioned on the question.ⁿ¹³¹

Chancellor Allen then turned to the open question, under Delaware law, of "whether in practice the waste standard that is utilized where informed shareholders ratify a grant of options adopted and recommended by a self-interested board is the classical waste test (*i.e.*, no consideration; gift; no person of ordinary prudence could possibly agree, etc.) or whether, in fact, it is a *species of intermediate review* in which the court assesses reasonableness in relationship to perceived benefits."ⁿ¹³² Chancellor Allen concluded that, while the "Supreme Court has not expressly deviated from the 'proportionality' approach to waste of its earlier decision," in fact the more recent cases more consistently seem to apply the bright-line test--absence of *any* consideration.ⁿ¹³³

Thus, Chancellor Allen applied what he had described as the "classical waste test" in denying the motion to dismiss the waste claim before him (despite shareholder ratification):

Giving the pleader the presumptions to which he is entitled on this motion, I cannot conclude that no set of facts could be shown that would permit the court to conclude that the grant of these options ... constituted an exchange to which no reasonable person not acting under compulsion and in good faith could agree. In so concluding, I do not mean to suggest a view that these grants are suspect, only that one time option grants to directors of this size seem at this point sufficiently unusual to require the court to refer to evidence before making an adjudication of their validity and consistency with fiduciary duty.ⁿ¹³⁴

The distinction between (a) compensation decisions made by a disinterested board of directors, which are protected under the business judgment rule, and (b) alleged waste of corporate assets, which is not, is well illustrated in *Kaufman v. Beal*.ⁿ¹³⁵ *Kaufman* was a shareholders' derivative lawsuit challenging allegedly excessive and wasteful compensation paid to directors and officers of Englehard Minerals and Chemicals Corporation ("EMC"). Part of the challenged payments were to be made in connection with the planned spinoff of EMC's mining, refining and manufacturing operations. EMC had proposed to distribute to company employees about \$16 million, about \$6.3 million of which would go to company officers (some of whom were also directors), "in recognition of the lost opportunity of these employees to participate in the future success of the mining, refining and manufacturing activities to be conducted by the ... [company whose shares were being spun off to EMC's shareholders]."ⁿ¹³⁶ The other challenged payments resulted from increases in compensation and benefits that the EMC board had approved between 1979 and 1981 for EMC inside directors.

In ruling on a motion to dismiss the derivative complaint for the plaintiffs' failure to make a pre-suit demand on the board of directors, the court held that EMC's board of directors was entitled to the protection of the business judgment rule with respect to the pay increases, which had been approved by a majority of disinterested directors, and therefore that the plaintiffs would not be excused from making a pre-suit demand on the board of directors.ⁿ¹³⁷ In contrast, the

court held that pre-suit demand was excused in connection with the alleged \$16 million payments made to compensate directors and employees for the "loss of opportunity" in connection with spin-off of certain of EMC's operations:

The claims concerning the alleged waste of assets due to the 16 million dollar payments made to compensate officers and employees for lost opportunities due to the spin off ... will not be dismissed, however [T]he payments to be made were for the lost opportunity of certain key employees ... to continue to participate in the mining, refining and manufacturing activities to be conducted in the future by the ... [spun-off corporation], with which they would not be affiliated. The amended complaints more specifically charge that these payments are wasteful and allege that no benefit accrued to EMC-Phibro from these payments.

Although the payments for lost opportunity ... are, therefore, alleged to be a total waste of assets for which no consideration was received, there is no allegation that a majority of the directors were to receive any of this largess or that any of the directors acted improperly in reviewing the transaction.

Nevertheless, it is possible, in the unusual circumstances present here, to infer that the directors' actions were not protected by the business judgment rule because it can be inferred that the transaction was totally unrelated to a corporate purpose ... or is one in which the consideration received by the corporation was 'so inadequate that no person of ordinary sound judgment would deem it worth what the corporation paid.' ... In such case, there would not be any protection afforded by the business judgment rule because, although directors are ordinarily not subject to personal liability, if they perform their duties properly, they are personally liable if they allow corporate assets to be wasted through gross negligence (or perhaps ordinary negligence)

If the complaint, therefore, alleges facts which, if true, show that the underlying transaction is totally unconnected to a valid corporate purpose, demand can be excused because the very nature of the transaction, as approved by the Board, calls the business judgment of the Board into question and mandates further judicial scrutiny.ⁿ¹³⁸

The court went on further to distinguish between a board's ordinary compensation decisions and transactions that, on their face, lack any cognizable corporate purpose:

Although compensation levels are normally the domain of the Board of Directors, the alleged substantial payments for lost opportunity to share in future benefits are in a different category. These payments were not apparently for services rendered The individuals are allegedly being paid for a lost opportunity which was not theirs to begin with but which belonged to the corporation and its stockholders because the opportunity to work for and share in the company's success is itself an asset of the company which it gives, along with financial compensation, in exchange for service Unless these individuals are being reimbursed for loss of contractual rights or there is some benefit to the corporation arising from the payments, it is possible that the employees' loss should not be compensated at all. Based on the limited record here, I find that the plaintiffs have, at least, successfully alleged that payment completely unrelated to a corporate purpose has occurred.ⁿ¹³⁹

In *Disney IV*, discussed above, having rejected the arguments that the Disney board's approval of a contract with Michael Ovitz (under which, eventually, \$140 million was paid out upon Ovitz's termination of employment) constituted a breach of the directors' fiduciary duties, the Delaware Supreme Court also rejected the claim that the challenged payments constituted corporate waste.ⁿ¹⁴⁰ Observing that the facts alleged do "not come close to satisfying the high hurdle required to establish waste",ⁿ¹⁴¹ and "[b]ecause the appellants have failed to show that the approval of the N[o] F[ault] [T]ermination terms of the O[vitz] E[m]ployment A[g]reement was not a rational business decision," the court concluded that the "waste claim must fail."ⁿ¹⁴²

These cases show that, despite the vitality of the business judgment rule and its applicability to executive compensation decisions made by disinterested boards of directors on adequate information and after due deliberation, the business judgment rule will not insulate a board of directors from claims of corporate waste where the board authorizes the expenditure of funds for which no reasonable person could conclude that there is a valid corporate purpose (compensatory or otherwise). Such expenditures are especially vulnerable to claims of corporate waste when interested directors have approved the challenged transaction--the context in which most successful claims of corporate waste have been litigated under Delaware law in recent years. Nevertheless, in theory, even expenditures of funds authorized by non-interested, independent directors can be attacked as a waste of corporate assets where no reasonable person could conclude that they have a legitimate corporate purpose; in practice, of course, it is much more difficult to persuade a court that a transaction could not reasonably be found to have a legitimate corporate purpose when it has been approved by a disinterested and informed board, on adequate information and after due deliberation (that is, by directors who are presumed to have acted reasonably).

[7] Cases on Change-in-Control Contracts

In general, at common law, change-in-control contracts (so-called "golden parachutes") follow the same analysis under the business judgment rule (if they are adopted and approved by disinterested directors acting on adequate information, in good faith and after due deliberation) as challenges under state law to other forms of executive compensation. Nevertheless, a handful of cases have dealt specifically with change-in-control contracts, including the policy arguments in support of and against such contracts. These are discussed below.

*Gaillard v. Natomas Co.*¹⁴³ was shareholder derivative litigation arising from the merger of Natomas Company into Diamond Shamrock Corporation. Shareholders of Diamond Shamrock brought the lawsuit to challenge "golden parachute" payments and other benefits provided to five Natomas inside directors in connection with the merger.

In 1983, Natomas was a publicly held company. The directors of Natomas were five executive officers and 12 outside directors (all of whom were later named as defendants in the lawsuit). In May of that year, Diamond Shamrock launched a hostile tender offer to acquire 51 percent of Natomas's outstanding common stock, with the stated intention of acquiring the remaining shares in a back-end merger. After considering several alternatives, representatives of Natomas agreed to meet with representatives of Diamond Shamrock on May 29, 1983.

After scheduling, but before holding, the May 29 meeting with representatives of Diamond Shamrock, Natomas's CEO and board chairman, Dorman Commons, directed the Natomas compensation committee to meet on May 30, the day after the scheduled meeting with Diamond Shamrock, to review proposed amendments to executive employment agreements of key executives. At the time, two of the senior executives (Commons and the Vice Chairman of Natomas, Kenneth Reed) already had contracts under which, if the employment of Commons were terminated for any reason other than for cause, he would be entitled to continuation of his \$450,000 annual salary for three years and, in the event of a merger or takeover, Reed would be entitled to payment of his annual base salary for the remainder of the three-year term of his agreement.

At the May 29 meeting, Commons led a team that included Joseph Flom, Natomas's outside counsel. The Diamond Shamrock team was led by William Bricker, the company's chairman and CEO. After the group meeting, Commons and Bricker met alone and agreed on the terms of a friendly merger in lieu of the continuation of the Diamond Shamrock tender offer.

Commons then met with the Natomas team, including Flom, to discuss the executive employment agreements. Commons suggested that he propose to Bricker severance agreements for all employees and the amendment of employment agreements for 17 key executives to include golden parachute provisions comparable to those in effect for Diamond Shamrock executives. Thereafter, Commons met with Bricker to present these proposals. Bricker consented to the proposed agreements shortly thereafter.

Commons returned to the Natomas group and directed Flom to prepare agreements with the new golden parachute provisions for Commons to review before the meeting of the compensation committee the following morning. The next morning, May 30, Flom reviewed with Commons the drafts he had prepared.

The amended agreements provided that Commons and Reed could terminate their employment within six months following the merger for Good Reason (a defined term) or thereafter for any reason and, having done so, that they would be entitled to receive a lump-sum payment equal to five times their total annual compensation (subject to downward adjustment to the extent that they remained in the employ of Natomas after the six-month period). The draft golden parachute agreements for the other inside directors provided for lesser, but nevertheless enhanced, severance payments if they left the employ of Natomas after the merger under similar circumstances.

The compensation committee and board of directors met that day, May 30, starting at 10:00 a.m. The compensation committee members were five of the 12 outside directors. Commons and Flom (among other non-committee members) attended the meeting, as well. At the outset, Commons announced that Natomas had reached a tentative merger agreement with Diamond Shamrock and explained the general terms of the agreement. He then said that Flom would address employee compensation matters and he left the meeting. Flom addressed several details of the proposed arrangements, including the major terms of the proposed employment agreements, of which the compensation committee members were also given a written summary. Flom advised the directors of the importance of having "management clearly in place" upon the consummation of the merger. He said that the proposed agreement would ensure continuity in management. He also reported that the proposed agreements were acceptable to Diamond Shamrock.

The committee concluded the meeting by agreeing to the recommended employment agreements with the golden parachute provisions. The committee chair stated that, in approving the proposed agreements, the committee relied heavily on Flom. The committee adjourned at 11:55, less than two hours after the meeting began.

The full board then met. The directors and their advisors discussed the terms of the proposed merger. Following that discussion, the members of management who had been present up to that point left the meeting and Flom discussed the proposed changes in the employment agreements. At the conclusion of the meeting, the directors approved the terms of the proposed merger and the proposed amendments to the employment agreements. At the end of June, there was a further meeting of the compensation committee and of the board of directors. The compensation committee approved the final forms of the proposed employment agreements. The board then met and, with the five inside directors abstaining, accepted the recommendation of the compensation committee and approved the amended employment agreements.

Shortly after the closing of the merger, all four key executives who were the beneficiaries of the agreements terminated their employment with Natomas. A Diamond Shamrock shareholder brought the derivative action, alleging that the Natomas directors had breached their fiduciary duties and had committed waste and mismanagement, negligence and conversion in approving and implementing the new golden parachute agreements in the midst of the merger negotiations. The trial court granted the defendants' motion for summary judgment, a decision from which the plaintiff took an appeal.

The appellate court began its analysis of the claims with a discussion of the California business judgment rule, including its limits:

Notwithstanding the deference to a director's business judgment, the rule does not immunize a director from liability in the case of his or her abdication of corporate responsibilities. ' ... When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment--reasonable diligence--has in fact been exercised. A director cannot close his eyes to what is

going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment¹⁴⁴

The court then reviewed the California statutory codification of the business judgment rule, which the court characterized as "incorporat[ing] the concept of a director's immunity from liability for an honest mistake of business judgment with the concept of a director's obligation of reasonable diligence in the performance of his or her duties"¹⁴⁵

The court took note of the policy arguments in favor of golden parachutes:

Corporate takeovers often threaten the financial and professional security of the managers of target companies. The theoretical purpose of golden parachutes is to shelter senior executives from such a threat. To this end, the two principal recognized functions of golden parachutes are (1) to foster executive objectivity toward merger and tender offers; and (2) to attract top executives to companies and industries where the odds of takeover are high As to the first function, a threatened takeover gives rise to the potential for conflict between executives' personal interests and the interests of shareholders. Golden parachutes align the interests of management more closely with those of shareholder by insuring executives against the possible pecuniary or nonpecuniary losses that may result from a change in control

As to the second function, golden parachutes provide long-term incentives for top quality management executives to enter industries and corporations in which the potential for takeover is above average

Most commentators agree that, in view of these two functions of golden parachutes, a golden parachute should be negotiated as part of an executive's overall compensation package, and that parachutes enacted in the midst of takeover negotiations should be discouraged. A parachute conferred following a tender offer will likely have little value in creating executive objectivity because the executives generally already will have taken an initial position on the takeover before the golden parachutes are adopted and may not be able to credibly take a different stance at a later time. Further, during a takeover battle, the target corporation has no need for the parachute's executive-recruiting functions. For these reasons, parachutes that are adopted in response to actual takeover overtures have been viewed as last minute appropriations of corporate assets or, alternatively, attempts to discourage potential acquirors.¹⁴⁶

Against this background of the California business-judgment rule and the theoretical justifications for and limits on the use of golden parachutes, the court proceeded to analyze the sufficiency of the causes of action in the derivative complaint. Interestingly, the court held that the five inside directors, who had abstained from voting on the golden parachute contracts, were not entitled to the protection of the California business judgment rule because "they were not performing the duties of a director in seeking approval of the agreements or accepting the benefits thereunder."¹⁴⁷ At least if the case had been analyzed under the law of other states, one might concurrently conclude that, since they had abstained from participating in the challenged vote and therefore could not have violated their fiduciary duties as directors in connection with the granting of the contracts, the claims against them had been properly dismissed by the court below. Nevertheless, the *Natomas* court concluded that "[t]he record discloses issues of fact on appellants' claims of, *inter alia*, breach of fiduciary duty and waste as to the five inside directors, which cannot be resolved as matter of law on the basis of the record before us Summary judgment as to all five inside directors therefore must be reversed."¹⁴⁸

As to the outside directors, the court first noted that "[t]he record does not disclose any personal interest in the benefits, and does not show any conflict of interest or evidence of bad faith on their part in approving the benefits."¹⁴⁹ The

court nevertheless concluded that there were controverted issues of fact bearing on whether the outside directors acted with due care, after reasonable inquiry, so as to be entitled to the protection of the California business judgment rule.¹⁵⁰ In analyzing this issue, the court noted that the compensation committee approved amended employment agreements for 17 key executives after only an initial two-hour meeting. The court questioned whether the members of the committee could reasonably have relied on Flom's justification for the contracts--that they would serve the essential purpose of promoting management continuity--without inquiring further into the circumstances and the basis for Flom's advice.

The court went on to observe that, because the golden parachute amendments were conceived of and entered into only after the terms of the merger had been negotiated and agreed upon, "the function of executive objectivity would not be served ... [and,] because they were provided to existing executives, the function of attracting top-level management obviously was not served." The court further questioned the reasonableness of the directors' accepting Flom's rationale about the utility of these contracts in the cases of Commons and Reed, who already had contracts with golden parachute features:

Significantly, the existing agreements for Commons and Reed, of which the committee members should have been aware, already provided golden parachutes which served the desirable functions of these forms of compensation. The record provides no explanation why these executives needed to make their benefits more 'golden.'¹⁵¹

Further, the court questioned the reasonableness of the directors' accepting Flom's rationale that the golden parachute features would ensure continuity of management:

The very terms of the amended agreements, however, indicate that the opposite purpose would be served, and that they in fact would encourage the executives to leave Natomas within the six-month period following the merger or shortly thereafter.¹⁵²

In addition, the court noted that "the compensation committee members should have been aware that Commons had proposed the amendment of the employment agreements and that Flom had been acting in accordance with Commons's instructions in preparing drafts of the employment agreement. Evidence of this close connection between Commons, a beneficiary of a golden parachute agreement, and Flom in formulating the terms of the agreements, would support the inference of self-dealing which should have been investigated further by the compensation committee."¹⁵³

For these reasons, the court found that there were questions of fact, which could not be resolved on a motion for summary judgment, about whether the outside directors had properly exercised the degree of diligence and due care, including the duty of inquiry, necessary to entitle them to the protection of the business judgment rule. Several aspects of the *Natomas* decision (a 1989 case)--including the court's reluctance to give any weight to directors' unquestioning reliance on the opinion of an outside expert and the court's refusal to credit directors' actions with the presumption of due care when the logical consequences of those actions did not square with their purported rationale--seem to presage more recent developments in the case law.

In the context of a board's approval of change-in-control agreements, the *Natomas* case exemplifies the difficulty of defending a change-in-control arrangement adopted in the midst of negotiations leading to a change in control. It also illustrates the importance, when boards consider and approve change-in-control arrangements, of avoiding undue influence on the part of executive officers, such as CEOs, who will benefit economically from those arrangements.

Aside from *Natomas*, most of the (admittedly few) cases explicitly dealing with change-in-control agreements adopted or approved by independent directors have upheld them under the business judgment rule. In *International Insurance Co. v. Johns*,¹⁵⁴ the court confronted what it characterized as a "case of first impression" namely, "whether the implementation of a 'golden parachute' agreement [approved] by a disinterested board of directors may be found to be a

breach of their fiduciary duty to the corporation; or whether the adoption of the Plan and Agreement [providing change-in-control benefits to senior executives] are protected from judicial interference by the business judgment rule."n155 The court held that the actions of the directors were protected by the business judgment rule, despite the argument that the change-in-control payments were made without adequate consideration, served no corporate purpose and amounted to a gift and waste of corporate assets.n156

In *In re Pennaco Energy, Inc. Shareholders Litigation*,n157 on a motion for a preliminary injunction, the Delaware Chancery Court ruled that the plaintiffs had failed to establish a likelihood that they would succeed on the merits of their claims attacking change-in-control arrangements adopted shortly before the company entered into a merger agreement, despite the fact that the challenged decisions had been made by interested directors. In that case, Pennaco shareholders sued for an injunction to block a tender offer for Pennaco, alleging, among other things, that the Pennaco directors had breached their fiduciary duties by putting their interests ahead of their duty to the shareholders in negotiating and approving lucrative change-in-control contracts for inside directors and other executives in contemplation of the sale of the company.

The Pennaco board and its compensation committee had held a series of meetings in late July through mid-November 2000. These meetings resulted in the company's (1) granting options, to directors and others, that would vest and become immediately exercisable upon a change in control; (2) entering into change-in-control contracts with several executives; and (3) making changes in existing change-in-control contracts that would increase their value to inside directors and other executives. At meetings on November 15, 2000, the board of directors discussed and its compensation committee approved proposed contract changes that made the change-in-control payouts more lucrative for the executives (but which, the court later found, also conferred certain benefits, including tax benefits, on the corporation). The same day, Pennaco signed a confidentiality agreement with Marathon Oil Company, allowing Marathon to commence due diligence on Pennaco the next day. Marathon had contacted Pennaco initially on September 8 and again on November 8 to explore the possibility of a business combination.

In the case of Pennaco's two most senior executives, who were also on the company's board of directors, the changes that the board approved on November 15 substantially increased the severance payments they would receive upon a change in control. In exchange for these changes, they entered into non-compete agreements, which conferred tax benefits on the company. The contracts of three of Pennaco's five directors were "materially affected" by the changes the board approved on November 15 and, at the same meeting, certain change-of-control-related benefits were approved for the two outside directors, as well.

On December 22, 2000, the Pennaco board approved a transaction under which Marathon would acquire Pennaco for \$19 per Pennaco share in a tender offer (presumably to be followed by a back-end merger, although the opinion is not explicit on this point). Marathon commenced its tender offer on January 8, 2001. The next day, shareholders sued claiming, among other things, that "Pennaco's two top-ranking officers, who are on the Pennaco board, loaded themselves up with severance benefits and options in contemplation of a sale. These officers, plaintiffs contend, were motivated to secure less than the best price and diverted an unfair portion of the sale price to themselves."n158

Though not without expressing some skepticism, the court rejected the claim that the board's approval of the change-in-control benefits was improperly motivated by the directors' self-interest. Stressing that, despite the timing, he did not find that the changes in the change-in-control payments were made in contemplation of an imminent change in control, and finding that there were valid business reasons from the corporation's point of view for the changes in the employment contracts, Vice Chancellor Strine ruled that the plaintiffs had not demonstrated likelihood of success on the merits of their attack on the golden parachute arrangements:

The plaintiffs also note that the process by which the Pennaco board set executive compensation was not one that would be applauded by commentators who believe that independent, non-management directors should take the lead on such matters. Although Pennaco had a compensation committee, that

committee appears to have met only at brief intervals in the middle of board meetings. It was content to let management take the laboring oar on proposing compensation arrangements. Indeed, it was Rady and Warren [Pennaco's two most senior executives, who were also directors] who worked with Arthur Andersen, not the compensation committee. Although the plaintiffs' arguments have obvious color, the plaintiffs have not convinced me that they are likely to succeed in proving that the options and new employment agreements granted to board members in the year 2000 were the product of a breach of fiduciary duty. Historically, Delaware courts have been quite reluctant to second-guess compensation decisions made by boards, even though those decisions always can be seen as clubby, or even as blatantly self-interested. Candidly, the defendant-directors' adamant insistence that the timing of the amendments to Rady's and Warren's employment agreements had nothing to do with Marathon's interest and a possible imminent sale of the company strikes me as implausible. Perhaps I am overly cynical, but this Mayberry R.F.D.n159 view of the business world is hard to accept. Here, plaintiffs also have the advantage of attacking a board that failed to use procedural protections to diminish the possibility that self-interest would taint its compensation decisions. For example, the November 15 changes to Rady's and Warren's agreements were recommended by Warren himself, and were voted on by a board majority comprised of Rady, Warren, and director Gibson, who himself was the beneficiary of similar changes.

Even so, other facts lead me to conclude that the plaintiffs have not met their burden. For starters, the record supports the inference that the board was examining changes in compensation policy long before Marathon came along. The changes made to executive compensation at the July 28, 2000 meeting were consistent with the changes later made to Rady's and Warren's packages

As important, there appears to have been a non-pretextual business rationale for the changes that were made. The plaintiffs have not disputed that the tax ramifications of the existing Change in Control Severance packages were severe, both to the executives who possessed those packages and any acquiror. Given the strong performance of the company, it was hardly outrageous to think that the board would reward its management with gross-up protection and increased Change in Control Severance in exchange for a non-compete, especially when the cost of the increased Severance would be at least partially offset by the tax protections gained thereby.

Similarly, the board's grant of options to itself on July 28, 2000 was consistent with a policy of aligning the board's interests with those of the stockholders. This is a permissible purpose

Moreover, although I incline towards the view that the November 15 changes were made *when* they were because of the serious possibility of a change in control, I am unconvinced that the Pennaco board believed such a transaction was imminentn160

In *Campbell v. Potash Corp. of Saskatchewan, Inc.*,n161 executives sued an acquiror ("PCS") of their former employer ("Arcadian") for golden parachute payments that the acquiror (under an assumption agreement) was obligated to make upon the change in control following by the termination of the executives' employment. On appeal from a decision of the lower court granting summary judgment in favor of the executives, the Court of Appeals rejected the argument that golden parachute agreements (which had been approved by a disinterested board) violate public policy. Rather, the court held, the target company board's decision to approve the contracts in question was protected by the business judgment rule:

PCS next argues that the golden parachutes violate public policy, and therefore that the assumption agreement promising them is void At most this court has frowned on golden parachutes in past dicta, but we have never held that such severance packages are *per se* unlawful

PCS further argues that these golden parachutes violate public policy because they were approved after the merger had been approved, and therefore served no legitimate corporate purpose. Though

adopted after the merger was approved, these golden parachutes were authorized later in the same meeting at which the approval occurred. Thus, PCS's argument that their adoption violated public policy because it came after approval of the merger is somewhat misleading. Moreover, the timing of the adoption of the golden parachute provision fits with the rationale given for their adoption in deposition testimony by Arcadian's then-directors. With a merger pending, the company feared that its top personnel might seek lucrative offers elsewhere. Not only would the company then be deprived of the services of key employees in the interim (and potentially receive less value from a merger if the firm suffered from poor management just prior to closing), but it also risked no longer having the managers who had brought so much profit to Arcadian in the event that the merger was never consummated. To ensure that neither of those situations occurred, Arcadian used golden parachutes to entice nine of its top executives to remain with the company until and unless there was both a change of corporate control and a decline in those executives' respective positions in the company

Mixed with its argument about public policy, PCS argues against application of the business judgment rule to this case PCS repeatedly refers to the *Gaillard* case as similar, but a California appeals court case applying California law is not binding precedent for this circuit's application of Delaware law And while the *Gaillard* case is factually similar in some respects, we do not find its reasoning persuasive. The district court in this case found no gross negligence on the part of the Arcadian board, and our court is less willing than California courts to question a corporate board's business judgment

Even if we ourselves did not perceive a good rationale for these parachutes, courts should be loath to condemn a business practice simply because they do not perceive a good rationale for a given practice. Condemning poorly understood practices simply for lack of a clear rationale would substitute the court's business judgment for the corporation's In short, evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts.

In Delaware, whose law the parties agreed would govern disputes under this contract, a plaintiff must show that the majority of the board acted in a manner that 'rises to the level of gross negligence' before a court may second guess its business judgment [In this case, b]oard members had a reasonable amount of accurate information about the severance packages before them when they acted. The lack of a completely accurate total outlay estimate before approval does not rise to the level of gross negligence

The Arcadian board therefore exhibited nothing like the lack of knowledge and the swiftness of deliberation condemned in the *Van Gorkom* or *Hanson* cases. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) ; *Hanson Trust PLC*, 781 F.2d 264 (2d Cir. 1986) Nor do the severance agreements at issue here approach the possibly wasteful use of corporate assets entailed in the Walt Disney Company's non-fault termination of Michael Ovitz recently adjudicated by the Delaware Supreme Court. See *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000) (dismissing the action without prejudice on procedural grounds, but observing that "the sheer size of the payout to Ovitz [\$ 140 million for less than 15 months of work] ... pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions"). If the Ovitz severance payment, which included \$ 39 million in cash, only pushes the envelope under Delaware law, then the smaller sum here spread across three executives with longer tenure at their company is well within the confines respected by the business judgment rule.n162

Despite the cases cited above (other than *Natomas*) holding that disinterested boards' decisions to authorize golden parachute contracts were protected under the business judgment rule, in the post-Enron context, such arrangements are likely to come under increasing attack in the courts (as they have in the press , in shareholder proposals submitted at annual meetings of companies, and in federal legislation such as the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009), and some courts may take a more jaundiced view of these

arrangements. Change-in-control arrangements are most likely to withstand legal challenge if they are designed, evaluated and approved in accordance with these principles:

1. A board's decision to approve change-in-control arrangements is more defensible when it is made before the commencement of negotiations leading to the very change in control that triggers the challenged payments.
2. The negotiation and review of change-in-control contracts should be undertaken by a vigorously independent committee (such as the compensation committee or another committee consisting entirely of disinterested outside directors) without undue influence on the part of any executive (such as the CEO) who will benefit from the change in control payments.
3. Legal counsel and consultants advising the board in connection with change-in-control contracts should be retained by, and should be accountable solely to, the independent directors, rather than to executive management.
4. Boards or committees should have ample time to fully understand the legal, financial and business aspects of, and rationales for, the change-in-control arrangements under consideration, when necessary with the assistance of their own independent legal and executive compensation advisors.
5. Before approving any change-in-control arrangement, the directors should be able to articulate a clear and logical rationale for the benefits that will flow to the corporation and its shareholders.
6. In evaluating proposed change-in-control arrangements, boards or the disinterested directors charged with the task should be sure that they have a clear and precise understanding of the potential total cost of the payments and other benefits that may be triggered under these arrangements, both in absolute dollar terms and as a percentage of the company's total market capitalization.
7. Change-in-control contracts should normally be "double trigger"--meaning that the payments and benefits payable under them should be due only in the event of (a) a change in control, followed by (b) involuntary termination by the company of the executive's employment without cause or voluntary termination of employment by the executive for good reason (carefully defined to ensure that there has been a diminution in the executive's compensation, benefits, responsibilities, position within the company, or other unfavorable change in the terms and conditions of the executive's employment, such as a relocation requirement, before an executive may voluntarily terminate employment and trigger change-in-control payments).

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate LawCorporationsDirectors & OfficersCompensationGeneral Overview

FOOTNOTES:

(n1)Footnote 1. The SROs are the registered national securities exchanges (the largest of which are the New York Stock Exchange (the "NYSE") and the American Stock Exchange (the "AMEX")) and the National Association of Securities Dealers (the "NASD"), which owns and operates the NASD Automated Quotation system (the "NASDAQ"). The SROs are subject to oversight by the SEC, which is required to approve the SROs' rules. *See* 17 U.S.C. § 78s(g)(1) (2000).

(n2)Footnote 2. The SEC's proxy statement disclosure requirements relating to executive compensation can be

found in Regulation S-K Items 402 and 407, 17 CFR §§ 229.402, 229.407. See A.A. Sommer, Jr. (Gen. Ed.), *Federal Securities Exchange Act of 1934 § 4.03[5][b]* for discussion of Regulation S-K Item 402.

(n3)Footnote 3. See Emergency Economic Stabilization Act of 2008; American Recovery and Reinvestment Act of 2009.

(n4)Footnote 4. *Winkelman v. General Motors Corp.*, 39 F. Supp. 826 (S.D.N.Y. 1940) .

(n5)Footnote 5. *Winkelman*, 39 F. Supp. at 827 .

(n6)Footnote 6. *Winkelman*, 39 F. Supp. at 830 .

(n7)Footnote 7. *Winkelman*, 39 F. Supp. at 833-834 (citations omitted).

(n8)Footnote 8. *Holthusen v. Edward G. Budd Mfg. Co.*, 52 F. Supp. 125 (E.D. Pa. 1943) .

(n9)Footnote 9. *Holthusen*, 52 F. Supp. at 126 . "Out-of-the-money" or "underwater" stock options are options whose exercise price exceeds the current trading price of the shares to be issued upon exercise. An annotated glossary of executive compensation terminology, by the National Association of Corporate Directors, is reproduced in this treatise as Appendix 15-B above .

(n10)Footnote 10. *Holthusen*, 52 F. Supp. at 128 .

(n11)Footnote 11. *Holthusen*, 52 F. Supp. at 129 .

(n12)Footnote 12. *Holthusen*, 52 F. Supp. at 129 .

(n13)Footnote 13. *Holthusen*, 52 F. Supp. at 129 .

(n14)Footnote 14. *Holthusen*, 52 F. Supp. at 130 .

(n15)Footnote 15. *Rogers v. Hill*, 289 U.S. 582 (1933) .

(n16)Footnote 16. *Holthusen*, 52 F. Supp. at 130-131 .

(n17)Footnote 17. See § 16.01[3] below.

(n18)Footnote 18. Options with a strike price below the current trading price of the stock are referred to as being "in the money"; options with a strike price equal to the current trading price of the underlying stock are "at the money."

(N19)Footnote 19. E. Lie, "On the Timing of CEO Stock Option Awards," 51 Mgt. Science No. 5 (May 2005), available at <http://www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf>.

(n20)Footnote 20. 2007 U.S. Dist. LEXIS 89989 (D. Mass., Dec, 4, 2007) .

(n21)Footnote 21. *Id.* at *3-*4 .

(n22)Footnote 22. 15 U.S.C. § 7243 (requiring the chief executive officer and chief financial officer of public companies to reimburse the issuer for profits and bonuses in any 12-month period following the first public issuance or filing of a financial statement that was subsequently restated due to material noncompliance with reporting requirements "as a result of misconduct").

(n23)Footnote 23. 2007 U.S. Dist. LEXIS 89989 at *31 ; accord, *In re InfoSonics Corp. Derivative Litig.*, 2007 U.S. Dist. LEXIS 66043 at *23-*24 (S.D. Cal., Mar. 21, 2007) .

(n24)Footnote 24. 2007 U.S. Dist. LEXIS 80558 (S.D.N.Y., Oct. 31, 2007) .

(n25)Footnote 25. *Id.* at *32-*36 .

(n26)Footnote 26. 2007 U.S. Dist. LEXIS 80558 at *35-*35 ; *accord*, *In re UnitedHealth Group PSLRA Litig.*, 2007 U.S. Dist. LEXIS 40623 (D. Minn., June 4, 2007) (denying motions to dismiss claims based on backdating allegations); *In re Zoran Corp. Derivative Litig.*, 511 F. Supp. 2d 986 (N.D. Calif. 2007) (denying motions to dismiss both federal securities fraud claims and Delaware state law claims for options backdating). *But see* *Weiss v. Amkor Technology, Inc.*, 2007 U.S. Dist. LEXIS 71688 at *29-*30 (D. Ariz., Sept. 25, 2007) (holding that merely pleading membership on a compensation committee that approved backdated stock option grants was insufficient to satisfy the scienter requirement under the federal securities laws); *In re Verisign, Inc. Derivative Litig.*, 2007 U.S. Dist. LEXIS 72341 at *83-*85 (N.D. Cal., Sept. 14, 2007) (finding that generalized allegations of options being backdated in violation of plan terms did not sufficiently allege scienter of directors who had approved the grants); *In re Atmel Corp. Derivative Litig.*, 2007 U.S. Dist. LEXIS 54058 (N.D. Cal., July 16, 2007) (allegations of backdating were insufficient to state claims under stringent federal pleading requirements in the absence of specific facts about the involvement of the individual defendants in the wrongdoing at issue).

(n27)Footnote 27. 128 S. Ct. 761, 6 EXC 62 (2008) .

(n28)Footnote 28. 918 A.2d 341 (Del. Ch. 2007) .

(n29)Footnote 29. *Id.* at 355-56 ; *accord*, *Conrad v. Blank*, 2007 Del. Ch. LEXIS 130 (D. Ch., Sept. 7, 2007) (denying, on demand-futility grounds, motion to dismiss shareholder derivative claims against officers and directors for backdating stock options). In contrast, in several other option-manipulation cases, federal courts have dismissed purported shareholder derivative suits for failure to satisfy the demand requirement (or to persuade the court that demand should be excused) under state law. *See, e.g.*, *In re Bed Bath & Beyond Inc. Derivative Litig.*, 2007 U.S. Dist. LEXIS 85213 (D.N.J. November 19, 2007) ; *Wandel v. Eisenberg*, 2007 N.Y. Misc. LEXIS 4086 (N.Y. Sup. Ct., May 3, 2007) ; *In re Verisign, Inc. Derivative Litig.*, 2007 U.S. Dist. LEXIS 72341 (N.D. Cal., Sept. 14, 2007) ; *In e InfoSonics Corp. Derivative Litig.*, 2007 U.S. Dist. LEXIS 66043 (S.D. Cal., Mar. 21, 2007) ; *In re PMC-Sierra, Inc. Derivative Litig.*, 2007 U.S. Dist. LEXIS 64879 (N.D. Cal., Aug. 22, 2007) ; *Hawaii Laborers Pension Fund v. Farrell*, 2007 U.S. Dist. LEXIS 77777 (C.D. Cal., Aug. 27, 2007) .

(n30)Footnote 30. 918 A.2d 341, at 358 .

(n31)Footnote 31. 924 A.2d 908 (Del. Ch. 2007) .

(n32)Footnote 32. *Id.* at 914 .

(n33)Footnote 33. *Id.* at 914 .

(n34)Footnote 34. *Id.* at 915 .

(n35)Footnote 35. 924 A.2d 908 .

(n36)Footnote 36. 924 A.2d 908 at 930-931 .

(n37)Footnote 37. *Id.* at 916 .

(n38)Footnote 38. *Id.* at 917 .

(n39)Footnote 39. *Id.* at 916-917 .

(n40)Footnote 40. 919 A.2d 563 (Del. Ch. 2007) .

(n41)Footnote 41. The decisions in *In re Tyson Foods and Ryan* were issued February 6, 2007; the *Desimone* decision was issued June 7, 2007.

(n42)Footnote 42. *Id.* at 592 (quoting *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1052-53 (Del. Ch. 1996) (emphasis added)).

(n43)Footnote 43. *Id.* at 592 (footnotes omitted).

(n44)Footnote 44. *Id.* at 592, n.74 .

(n45)Footnote 45. *Id.* at 592, n.75 .

(n46)Footnote 46. 919 A.2d 563 at 592-93 (footnotes omitted).

(n47)Footnote 47. *Id.* at 593 . *But see In re Ditech Networks, Inc. Derivative Litig.*, 2007 U.S. Dist. LEXIS 51524, at *32-*32 (N.D. Cal., July 16, 2007) (dismissing spring-loading claims for failure to plead fraud with particularity under the Federal Rules of Civil Procedure).

(n48)Footnote 48. 924 A.2d 908 (Del. Ch. 2007) .

(n49)Footnote 49. *Id.* at 916-917 .

(n50)Footnote 50. 2007 Del. Ch. LEXIS 120 at *13 (Del. Ch. Aug. 15, 2007) .

(n51)Footnote 51. *In re Tyson Foods, Inc. Consolidated Shareholder Litig.*, 919 A.2d 563 (Del. Ch. 2007) .

(n52)Footnote 52. 2007 Del. Ch. LEXIS 120 at *3 .

(n53)Footnote 53. *Id.* at *2 (quoting *In re Tyson Foods, Inc. Consolidated Shareholder Litig.*, 919 A.2d at 593).

(n54)Footnote 54. 2007 Del. Ch. LEXIS 120 at *8 .

(n55)Footnote 55. 2007 Del. Ch. LEXIS 120 at *14 . As reprised by the court, the test enunciated in *Tyson I* comprised two "premises":

[The conclusion that spring-loading may not be an exercise of a good faith fiduciary] rests upon at least two premises, each of which should ... be alleged by a plaintiff in order to show that a spring-loaded option issued by a disinterested and independent board is nevertheless beyond the bounds of business judgment. First, a plaintiff must allege that options were issued according to a shareholder-approved employee compensation plan. Second, a plaintiff must allege that the directors that approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options.

2007 Del. Ch. LEXIS 120 at *14, n.19 (quoting *Tyson I*, 919 A.2d at 593).

(n56)Footnote 56. *Id.* at *14-*15 .

(n57)Footnote 57. *Id.* at *18 .

(n58)Footnote 58. *Id.* at *18-*19 .

(n59)Footnote 59. *Del. Code Ann. tit. 8, § 157* (emphasis added); *see also Fla. Stat. Ann. § 607.0624(1)* ("The

board of directors shall determine the terms upon which the rights, options, or warrants are issued, their form and content, and the consideration for which the shares are to be issued."); *Ind. Code* § 28-13-2-5 ("The board of directors shall determine the terms upon which the rights, options, or warrants are issued, their form and content, and the consideration for which the shares or other securities are to be issued. The rights, options or warrants may be issued with or without consideration ..."); *Kan. Stat. Ann.* § 17-6407 ("In the absence of actual fraud in the transaction, the judgment of the directors as to consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive."); *Mo. Ann. Stat.* § 351.182(2)(5) ("In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof and the terms of such rights or options shall be conclusive."); *Okla. Stat. Ann. tit. 18, § 1038* ("In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.").

(n60)Footnote 60. *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979) .

(n61)Footnote 61. "In the money" stock options are options whose exercise price is lower than the current market value of the shares to be issued upon exercise.

(n62)Footnote 62. *Michelson*, 407 A.2d 211, 223-224 (Delaware cases have indicated a "strong disfavor for summary judgment in stock option claims where waste of corporate assets is alleged" and the authority the defendants cited "should not be interpreted as contradicting the well-established rule that non-unanimous shareholder approval cannot cure an act of waste of corporate assets").

(n63)Footnote 63. *Michelson*, 407 A.2d 211, 223-224 .

(n64)Footnote 64. *Michelson*, 407 A.2d at 224 ("We do not read § 157 as intended to erect a legal barrier to any claim for relief as to an alleged gift or waste of corporate assets in the issuance of stock options where the claim asserted is one of absolute failure of consideration."); *see also Stein v. Orloff*, CA 7276, 1985 Del. Ch. LEXIS 418 at *11-*12 (May 30, 1985) (complaint adequately alleged Stock Option Committee's reduction of exercise price of outstanding stock options previously granted to directors, with no consideration to the corporation, constituted a waste of corporate assets).

(n65)Footnote 65. *Byrne v. Lord*, CA 14040, 1995 Del. Ch. LEXIS 131 (Nov. 9, 1995) .

(n66)Footnote 66. *See Byrne*, 1995 Del. Ch. LEXIS 131 at *10-*11 .

(n67)Footnote 67. *Byrne*, 1995 Del. Ch. LEXIS 131 at *11 ; *see also Beard v. Elster*, 160 A.2d 731 at 735-738 (Del. 1960) (construing and reaffirming two earlier, pre-section 152 Delaware cases on stock options-- *Kerbs v. Eastern Airways*, 90 A.2d 652 (Del. 1952) and *Gottlieb v. Heyden Chemical Corp.*, 33 Del. Ch. 82, 90 A.2d 660, 90 A.2d 660 --for the proposition that "All stock option plans must be tested against the requirement that they contain conditions, or that surrounding circumstances are such, that the corporation may reasonably expect to receive the contemplated benefit from the grant of the options. Furthermore, there must be a reasonable relationship between the value of the benefits passing to the corporation and the value of the options granted.").

(n68)Footnote 68. *Byrne*, 1995 Del. Ch. LEXIS 131 at *11 (citation omitted).

(n69)Footnote 69. *Byrne*, 1995 Del. Ch. LEXIS 131 at *12 .

(n70)Footnote 70. *Byrne*, 1995 Del. Ch. LEXIS 131 at *13 -*16.

(n71)Footnote 71. *Byrne*, 1995 Del. Ch. LEXIS 131 at *21 -*22.

(n72)Footnote 72. *Byrne*, 1995 Del. Ch. LEXIS 131 at *22-*23 (citation omitted).

(n73)Footnote 73. *Zupnick v. Goizueta*, 698 A.2d 384 (Del. Ch. 1997) .

(n74)Footnote 74. *Zupnick*, 698 A.2d at 387 .

(n75)Footnote 75. *Zupnick*, 698 A.2d at 386 .

(n76)Footnote 76. *Lieberman v. Becker*, 155 A.2d 596 (Del. 1959) .

(n77)Footnote 77. A "phantom share" plan is an arrangement under which participants are credited with the economic benefits (typically equal to dividends plus capital appreciation) of ownership of the company's shares, but without actually having a legal or beneficial interest in the company's stock. The total gains that a stockholder would derive in a given period of time are simply mimicked in book entries for the accounts of the participants and are payable, at specified times and under defined conditions, out of the general assets of the company (or, in some cases, out of assets set aside in a trust for purposes of funding the plan).

(n78)Footnote 78. *Lieberman*, 155 A.2d at 598 .

(n79)Footnote 79. *Lieberman*, 155 A.2d at 598 .

(n80)Footnote 80. *Lieberman*, 155 A.2d at 598 (citations omitted).

(n81)Footnote 81. *Lieberman*, 155 A.2d at 598 (citations omitted).

(n82)Footnote 82. *Lieberman*, 155 A.2d at 599 .

(n83)Footnote 83. *Lieberman*, 155 A.2d at 599 .

(n84)Footnote 84. *Lieberman*, 155 A.2d at 600 .

(n85)Footnote 85. *Lieberman*, 155 A.2d at 601 . The use of the word "management" in this passage is interesting but, in the context of the facts of this case, should be interpreted to mean the disinterested committee of directors charged with the administration of the plan.

(n86)Footnote 86. *Beard v. Elster*, 39 Del. Ch. 153, 160 A.2d 731 (Del. 1960) .

(n87)Footnote 87. *See* § 16.01[2] above.

(n88)Footnote 88. *Beard*, 160 A.2d at 738-739 .

(n89)Footnote 89. *Cohen v. Ayers*, 596 F.2d 733 (7th Cir. 1979) .

(n90)Footnote 90. *Cohen*, 596 F.2d 733 at 739-740 (7th Cir. 1979) . The court also analyzed the issue under New York statutory law, which it found to be "in accord with these general principles":

Under section 713 of the New York Business Corporation Law, an unratified contract in which a director has an interest is voidable unless the interested directors 'shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation' However, if the transaction is approved by the shareholders or the disinterested directors after the disclosure of all 'material facts,' the transaction is not voidable for 'substantial financial interest alone.' Although the statute is not explicit, we interpret these provisions, in accord with the general rule, as shifting the burden of proving the unfairness of the transaction to the challenging shareholder or director, one effective ratification occurs.

Cohen, 596 F.2d at 740 .

(n91)Footnote 91. *But see Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702 (Cal. Ct. App. 1989) , discussed in § 16.01[5] below.

(n92)Footnote 92. *International Ins. Co. v. Johns*, 685 F. Supp. 1230 (S.D. Fla. 1985) .

(n93)Footnote 93. *Johns*, 685 F. Supp. at 1231 .

(n94)Footnote 94. *Johns*, 685 F. Supp. at 1236 .

(n95)Footnote 95. *Johns*, 685 F. Supp. at 1236 .

(n96)Footnote 96. *Johns*, 685 F. Supp. at 1236 .

(n97)Footnote 97. *Johns*, 685 F. Supp. at 1237 .

(n98)Footnote 98. *Johns*, 685 F. Supp. 1230, 1237 ("Plaintiff contends that the approval and implementation of the Plan and Agreement was a waste of corporate assets because those who received the award provided no, or at least inadequate consideration for their payments. Moreover, Plaintiff contends that the awards under the Plan constitute illegal personal profit because the triggering event for the payments was not the loss of the Defendants' positions or change in their status, but merely the change in control of Southwest. Therefore, the Defendants were able to keep their positions, maintain their salary, and receive a sizable bonus merely because Southwest had been acquired.").

(n99)Footnote 99. *Johns*, 685 F. Supp. at 1237 .

(n100)Footnote 100. *Johns*, 685 F. Supp. at 1239 . The court therefore ruled that neither policy exclusion on which the insurer relied applied to this situation and that the insurer therefore had a duty under the policy to pay for the settlement of the underlying derivative litigation.

(n101)Footnote 101. *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (2006) .

(n102)Footnote 102. No. 602527/05, 2006 N.Y. Misc. LEXIS 2891, 235 NYLJ 126 (N.Y. Supp. Ct., June 23, 2006) .

(n103)Footnote 103. *Viacom*, 2006 N.Y. Misc. LEXIS 2891 at *11-*12 (quoting *In re Walt Disney Company Derivative Litigation*, 731 A.2d 342, 357-360 (Del. Ch. 1998)) .

(n104)Footnote 104. *Viacom*, 2006 N.Y. Misc. LEXIS 2891 at *18-*20 ("The entire fairness two prong test usually applies in cases whereby courts assess the fairness of a merger to the shareholders. It is also appropriate to apply the entire fairness analysis to evaluate the fairness of the executives' compensation package.").

(n105)Footnote 105. *California Pub. Employees' Ret. Sys. v. Coulter*, CA 19191, 2002 Del. Ch. LEXIS 144 (Dec. 18, 2002) .

(n106)Footnote 106. *Coulter*, 2002 Del. Ch. LEXIS 144 at *12-*13 .

(n107)Footnote 107. *Coulter*, 2002 Del. Ch. LEXIS 144 at *24, *28-*29 .

(n108)Footnote 108. *Coulter*, 2002 Del. Ch. LEXIS 144 at *28-*29 .

(n109)Footnote 109. *Coulter*, 2002 Del. Ch. LEXIS 144 at *33 .

(n110)Footnote 110. *Coulter*, 2002 Del. Ch. LEXIS 144 at *37-*38 .

(n111)Footnote 111. *But cf. Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732, 736 (Del. Ch. 2007) appeal dismissed,

Jerney v. Valeant Pharms. Int'l, (Del. Ch., May 30, 2007), in which a former officer and director of ICN Pharmaceuticals was held personally liable, based on breach of fiduciary duty and unjust enrichment theories, for the board of directors' unanimous approval of large cash bonuses to themselves and certain other ICN executives, in connection with a pending corporate spin-off. The Court of Chancery held that the compensation package should be reviewed under the entire-fairness standard, putting the burden on defendants to prove that the bonuses were fair, with respect to both the deliberative process in authorizing the compensation arrangement and its pricing terms. The ICN board's decision invited a high level of judicial scrutiny because of the evident self-dealing it reflected, as evidenced by the interested directors, conflicted members of the compensation committee, and the latter's retention, as its advisor, of the consulting company that had already given advice to management on the bonus proposal. Whether this case presages greater judicial scrutiny of compensation contracts approved under less egregious circumstances remains to be seen.

(n112)Footnote 112. *Stein v. Orloff*, CA 7276, 1985 Del. Ch. LEXIS 418 (May 30, 1985).

(n113)Footnote 113. *Orloff*, 1985 Del. Ch. LEXIS 418 at *6.

(n114)Footnote 114. *Orloff*, 1985 Del. Ch. LEXIS 418 at *6 -*7.

(n115)Footnote 115. See, e.g., § 11.06[2][a] above, discussing the *Oracle* case.

(n116)Footnote 116. *Orloff*, 1985 Del. Ch. LEXIS 418 at *10.

(n117)Footnote 117. *Orloff*, 1985 Del. Ch. LEXIS 418 at *10.

(n118)Footnote 118. See *Orloff*, 1985 Del. Ch. LEXIS 418 at *11 -*12 (at the time of the repricing, the Evans Products board consisted of 14 directors, of whom seven held more than three-quarters of the options that were subject to the repricing).

(n119)Footnote 119. *Orloff*, 1985 Del. Ch. LEXIS 418 at *12 -*13.

(n120)Footnote 120. See § 16.01[5] below.

(n121)Footnote 121. *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997).

(n122)Footnote 122. *Vogelstein*, 699 A.2d at 329.

(n123)Footnote 123. *Vogelstein*, 699 A.2d at 333.

(n124)Footnote 124. *Vogelstein*, 699 A.2d at 333-334.

(n125)Footnote 125. *Vogelstein*, 699 A.2d at 335 ("The idea behind this rule is apparently that a transaction that satisfies the high standard of waste constitutes a gift of corporate property and no one should be forced against their will to make a *gift* of their property. In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.") (emphasis in original).

(n126)Footnote 126. *Vogelstein*, 699 A.2d at 335.

(n127)Footnote 127. *Vogelstein*, 699 A.2d at 336.

(n128)Footnote 128. *Vogelstein*, 699 A.2d at 336.

(n129)Footnote 129. *Vogelstein*, 699 A.2d at 337.

(n130)Footnote 130. *Beard v. Elster*, 39 Del. Ch. 153, 160 A.2d 731 (Del. 1960) . See discussion in § 16.01[3] above.

(n131)Footnote 131. *Vogelstein*, 699 A.2d 327, 337-338 .

(n132)Footnote 132. *Vogelstein*, 699 A.2d at 338 (emphasis in original).

(n133)Footnote 133. *Vogelstein*, 699 A.2d at 338 .

(n134)Footnote 134. *Vogelstein*, 699 A.2d at 339 ; accord, *Leung v. Schuler*, CA 17089, 2000 Del. Ch. LEXIS 134 at *14 (Sept. 29, 2000) (in dismissing corporate waste claims, citing *Vogelstein*, 699 A.2d 327 (1997) , for the "functional equivalent to a gift" and "essentially no consideration" standards for corporate waste in a case where the challenged transaction had been approved by disinterested directors). For an unequivocal, clear-cut case of breach of fiduciary duty and waste of corporate assets involving executive compensation under Delaware law, see *Delta Star, Inc. v. Patton*, 76 F. Supp. 2d 617 (W.D. Pa. 1999) . In that case, without any board process whatsoever (let alone shareholder ratification), the CEO unilaterally granted to himself and other corporate executives lavish salary increases, bonuses, benefits and perquisites. Clearly, the business judgment rule could not be used as a defense in this case. In considering the waste claims, the court invoked both the "no reasonable relationship" and the "no person of ordinary, sound business judgment" tests. *Delta Star*, 76 F. Supp. 2d at 635-636 .

(n135)Footnote 135. *Kaufman v. Beal*, CA 6485, 6526, 1983 Del. Ch. LEXIS 391 (Feb. 25, 1983) .

(n136)Footnote 136. *Kaufman*, 1983 Del. Ch. LEXIS 391 at *2 .

(n137)Footnote 137. *Kaufman*, 1983 Del. Ch. LEXIS 391 at *9-*14 (observing that, "[i]f a challenged transaction is clearly protected from judicial scrutiny by the operation of the business judgment rule, a Board would not be personally interested in the outcome of the proposed litigation and would not be under a disability to consider a demand for redress ... [,]" and finding that a majority of the directors who had approved the compensation increases were not so interested, the Chancery Court held that pre-suit demand could not be excused insofar as the allegations of improper compensation and benefits increases were concerned).

(n138)Footnote 138. *Kaufman*, 1983 Del. Ch. LEXIS 391 at *14-*16 .

(n139)Footnote 139. *Kaufman*, 1983 Del. Ch. LEXIS 391 at *18-*19 .

(n140)Footnote 140. *In re Walt Disney Company Derivative Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *121-*124 .

(n141)Footnote 141. *In re Walt Disney Company Derivative Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *124-*125 .

(n142)Footnote 142. *In re Walt Disney Company Derivative Litigation*, No. 41,2005, 2006 Del. LEXIS 307, *126 .

(n143)Footnote 143. *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702 (Cal. Ct. App. 1989) .

(n144)Footnote 144. *Natomas*, 256 Cal. Rptr. 702, 710 , quoting *Burt v. Irvine Co.*, 237 Cal Rptr. 828, 852-853 (Cal. Ct. App. 1965) .

(n145)Footnote 145. *Natomas*, 256 Cal. Rptr. at 710 .

(n146)Footnote 146. *Natomas*, 256 Cal. Rptr. at 712 .

(n147)Footnote 147. *Natomas*, 256 Cal. Rptr. at 713 .

(n148)Footnote 148. *Natomas*, 256 Cal. Rptr. at 713 . Query whether officers, negotiating their own employment agreements, have fiduciary duties to the shareholders. The *Natomas* court apparently concluded that they do.

(n149)Footnote 149. *Natomas*, 256 Cal. Rptr. at 713 .

(n150)Footnote 150. *Natomas*, 256 Cal. Rptr. at 713-714 .

(n151)Footnote 151. *Natomas*, 256 Cal. Rptr. at 714 .

(n152)Footnote 152. *Natomas*, 256 Cal. Rptr. at 714 .

(n153)Footnote 153. *Natomas*, 256 Cal. Rptr. at 715 .

(n154)Footnote 154. *International Ins. Co. v. Johns*, 685 F. Supp. 1230 (S.D. Fla. 1988) , *aff'd*, 874 F.2d 1447 (11th Cir. 1989) .

(n155)Footnote 155. *Johns*, 685 F. Supp. at 1238 .

(n156)Footnote 156. *Johns*, 685 F. Supp. at 1238-1240 , *aff'd*, 874 F.2d 1447, 1456-1470 (11th Cir. 1989) (affirming conclusion of the court below that the directors' action in conferring the challenged payments benefits, characterized as "golden parachutes," was protected under the business judgment rule and did not amount to a waste of corporate assets, and reviewing at length the policy considerations surrounding the validity of such arrangements).

(n157)Footnote 157. *In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691 (Del. Ch. 2001) .

(n158)Footnote 158. *Pennaco*, 787 A.2d at 693 .

(n159)Footnote 159. The reference is apparently to an old television series in which small-town characters were portrayed as na"ive hicks.

(n160)Footnote 160. *Pennaco*, 787 A.2d 691, 708-709 (emphasis in original).

(n161)Footnote 161. *Campbell v. Potash Corp. of Saskatchewan, Inc*, 238 F.3d 792 (6th Cir. 2001) .

(n162)Footnote 162. *Campbell*, 238 F.3d 792, 799-801 (some citations and all footnotes omitted).



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Corporate Governance: Law and Practice

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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice § 16.02

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§ 16.02 Tax Laws Designed to Restrain "Excessive" Executive Compensation

In connection with two major executive compensation issues (the absolute level of executive compensation and change-in-control agreements), Congress has enacted tax laws to discourage perceived abuses in executive compensation. Thus, the Internal Revenue Code and the rules and regulations thereunder play a role in corporate governance in the area of executive compensation.

[1] Section 162(m) of the Internal Revenue Code

In 1993, Congress enacted *Section 162(m) of the Internal Revenue Code* ("IRC"), to eliminate the federal corporate income tax deductibility of compensation in excess of \$1 million for each "covered employee" (the CEO and the other three most highly compensated executive officers other than the CFO), with certain exceptions. The express purpose of Section 162(m) was to contain the level of executive compensation, which had become a subject of "scrutiny and criticism."¹

Since the effective date of Section 162(m), most major public companies have continued to pay their CEOs and other senior executives total compensation in excess of \$1 million. In some instances, companies forgo the tax deductibility of such compensation in excess of that amount. More commonly, however, companies have structured their compensation programs for named executive officers so as to qualify some or all of their compensation in excess of \$1 million for federal corporate income tax deductibility under the "qualified performance-based compensation exception" to Section 162(m)'s general rule of non-deductibility of compensation over \$1 million for each named executive officer. Because the regulations under Section 162(m) are highly procedural in nature, and because the required procedures must be administered by a committee of independent directors (typically, the board compensation committee), this subject is treated in detail in § 11.06[3] above.

This "qualified performance-based compensation exception" has come under attack in recent years as both the Internal Revenue Service and Congress have limited the scope of this exception. In order to qualify for the performance-based compensation exception, among other requirements, the compensation must be payable only upon the attainment of pre-established performance goals. The Treasury Regulations provide for a limited exception to this general rule for

payments made upon certain termination events (including death, disability and upon a change of control) without regard to whether the performance goals are attained. In March 2008, the IRS reversed its long-standing position and made clear that certain other termination events (including termination without cause, termination for good reason, and retirement) are not included within this exception, meaning payment made upon these events must be based on the attainment of pre-established performance goals in order to qualify as "performance-based compensation."ⁿ²

In October 2008, Congress enacted the Emergency Economic Stabilization Act ("EESA"), pursuant to which certain financial institutions receive federal assistance under the Troubled Assets Relief Program ("TARP"). Under EESA, TARP recipients are subject to executive compensation restrictions. Among other things, Congress amended *IRC Section 162(m)* to reduce the deductibility limit from \$1 million to \$500,000 for compensation paid by companies receiving TARP funds to the companies' senior executive officers (generally the top five highest paid officers). Significantly, for TARP recipients there is no longer an exception to this limit for "qualified performance-based" compensation.ⁿ³

[2] Golden Parachute Tax Laws (IRC §§ 280G, 4999)

In 1984, Congress enacted two provisions of the IRC designed to create corporate and individual tax penalties for excessive golden parachute payments made to certain corporate executives. *IRC Section 280G* penalizes the corporation by denying corporate tax deductions for such payments and *IRC Section 4999* penalizes the recipient by imposing a 20 percent excise tax on such payments.ⁿ⁴ The Treasury Regulations governing the application of the golden parachute tax rules are extensive and detailed, and they include many detailed examples of how they should be applied. These regulations are set forth in full in Appendix 16-A to this chapter. The following material summarizes the major provisions of the statute and regulations governing the application of the golden parachute tax rules.

Sections 280G and 4999 both apply to "excess parachute payments" made to "disqualified individuals." A "disqualified individual" is any individual who, during the "determination period," is (a) any employee or independent contractor of the corporation and is (b) a shareholder, officer or highly compensated individual.ⁿ⁵ The "determination period" is the 12-month period ending on the date of the change in ownership or control of the corporation.ⁿ⁶

For the purposes of the golden parachute tax rules, only individuals who own stock with a fair market value exceeding one percent of the fair market value of the outstanding shares of all classes of the company's stock are "disqualified individuals" by virtue of their stock ownership.ⁿ⁷ Stock underlying vested stock options as well as certain stock considered constructively owned under *IRC Section 318(a)* must be considered in determining an individual's percentage ownership.ⁿ⁸

Whether a person is an officer for purposes of the golden parachute tax rules "is determined on the basis of all the facts and circumstances of the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties)."ⁿ⁹ Nevertheless, "[n]o more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer))" of a corporation may be considered officers of that corporation for purposes of the golden parachute tax rules.ⁿ¹⁰

A highly compensated individual, for purposes of those rules, is (or would be, if he or she were an employee) in the group consisting of the lesser of (a) the most highly paid one percent of the corporation's employees (rounded up to the nearest integer) or (b) the most highly paid 250 employees of the corporation, when ranked on the basis of compensation.ⁿ¹¹

A "parachute payment" (1) is one that is

- (a) in the nature of compensation,

(b) made to a disqualified individual, and

(c) contingent on a change in the (I) ownership or effective control of the corporation, or (II) ownership of a substantial portion of the assets of the corporation;

if

(2) the aggregate present value of "the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to three times the base amount."¹²

Parachute payments also include "any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation (a "Securities Violation Parachute Payment")."¹³

The "base amount," for these purposes is the individual's "annualized includible compensation for the base period," meaning the average annual compensation includible in the individual's gross income for the most recent five taxable years ending before the date on which the change in ownership or control occurs.¹⁴

The "excess parachute payment"--which is not deductible on the corporation's federal income tax return and to which the 20-percent non-deductible excise tax applies to the recipient--is the portion of the parachute payment that exceeds the *base amount* (not three times the base amount).¹⁵

Nevertheless, as always with tax laws, these apparently simple rules are subject to many complications and exceptions. Among the most important exceptions, from the taxpayer's point of view, is the exclusion from the "parachute payment" of any amount that the taxpayer establishes by clear and convincing evidence is reasonable compensation either for (a) personal services to be rendered on or after the date of the change in control, or (b) for personal services actually rendered before that date.¹⁶ Such amounts paid for personal services may include "reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete)."¹⁷

Pursuant to a controversial rule adopted in the 2004 Treasury Regulations under Section 280G, transfers of statutory and nonstatutory stock options--including the vesting of such options--as a result of change in control are required to be valued taking into account specified factors and under "any method prescribed by the Commissioner in published guidance of general applicability under § 601.601(d)(2) of this Chapter."¹⁸

In connection with the issuance of those regulations, the Treasury Department also adopted a revenue procedure, restating and modifying two previously issued revenue procedures on the valuation of stock options for purposes of *IRC Sections 280G* and *4999*.¹⁹ In general, that revenue procedure allows a taxpayer to value a stock "using any valuation method that (i) is consistent with generally accepted accounting principles (such as FAS 123 or a successor standard) and (ii) takes into account the factors provided in § 1.280G-1, Q/A 13."²⁰ The Revenue Procedure goes on to provide that "the value of a stock option will not be considered properly determined if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change in ownership or control."²¹ Thus, even under-water stock options will often be ascribed some value for purposes of the golden parachute tax rules. The revenue procedure includes a safe-harbor method for valuing options for purposes of the golden parachute tax rules, based on the Black-Scholes model but allowing for the use of some simplified assumptions, for valuing stock options.²²

The Emergency Economic Stabilization Act of 2008 expanded the scope of *IRC Section 280G*, as applicable to

recipients of TARP funds, to apply the above-described golden parachute tax provisions to payments made to covered executives (the CEO, CFO and the top three highest paid officers other than the CEO and CFO) on account of any involuntary termination of employment (as opposed to only payments contingent upon a change of control).ⁿ²³

In addition, EESA prohibits TARP recipients from making any golden parachute payments to a senior executive officer during the period when TARP funds remain outstanding.ⁿ²⁴ The American Recovery and Reinvestment Act of 2009 ("ARRA") amended EESA to expand the scope of this prohibition, as discussed in *Section 16.06* of this chapter.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Directors & Officers Compensation

FOOTNOTES:

(n1)Footnote 1. Revenues Report to Accompany Recommendations from the Committee on Ways and Means, H.R. Rep. No. 103-111, at 646 (May 25, 1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877.

(n2)Footnote 2. *Revenue Ruling 2008-13, 2008-10 I.R.B. 518 (3/10/2008)* .

(n3)Footnote 3. EESA § 302(a).

(n4)Footnote 4. *See 26 U.S.C. §§ 280G, 4999.*

(n5)Footnote 5. *26 U.S.C. § 280G(c); 26 CFR § 1.280G-1 (Q&A 15).*

(n6)Footnote 6. *26 CFR § 1.280G-1 (Q&A 20).*

(n7)Footnote 7. *26 CFR § 1.280G-1 (Q&A 17).*

(n8)Footnote 8. *See 26 CFR § 1.280G-1 (A-17(b)).* For constructive ownership rules, *see 26 CFR § 1.318-1.*

(n9)Footnote 9. *26 CFR § 1.280G-1 (A-18(a)).*

(n10)Footnote 10. *See 26 CFR § 1.280G-1 (A-18(c)).*

(n11)Footnote 11. *26 CFR § 1.280G-1 (A-19(a)).*

(n12)Footnote 12. *26 U.S.C. § 280G(b)(2); 26 CFR § 1.280G-1 (A-2(a)).*

(n13)Footnote 13. *26 CFR § 1.280G-1 (A-2(c)).*

(n14)Footnote 14. *26 U.S.C. §§ 280G(b)(3), (d).*

(n15)Footnote 15. *26 U.S.C. § 280G(b)(1), (3).*

(n16)Footnote 16. *26 U.S.C. § 280G(b)(4).* In addition, there are four other, more-specialized exemptions that apply to small business corporations; certain payments with respect to corporations no stock in which is readily tradable on an established securities market (or otherwise); payments to or from a qualified plan; and certain payments made by certain tax-exempt organizations. *See 26 CFR § 1.280G-1(A-5).*

(n17)Footnote 17. *26 CFR § 1.280G-1 (A-40(b)).*

(n18)Footnote 18. *26 CFR § 1.280G-1 (A-13(a)).*

(n19)Footnote 19. *Rev. Proc. 2003-68, 2003-34 I.R.B. 398 (Aug. 25, 2003)* .

(n20)Footnote 20. *Rev. Proc. 2003-68* , § 3.01, *2003-34 I.R.B. 398 (Aug. 25, 2003)* . Those factors "include, but are not limited to: The difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised" (all of which are factors in the Black-Scholes formula). *26 CFR § 1.280G-1 (A-13(a))*.

(n21)Footnote 21. *Rev. Proc. 2003-68* , § 3.01, *2003-34 I.R.B. 398 (Aug. 25, 2003)* .

(n22)Footnote 22. *Rev. Proc. 2003-68* , § 4.01, *2003-34 I.R.B. 398 (Aug. 25, 2003)* .

(n23)Footnote 23. EESA § 302(b).

(n24)Footnote 24. EESA § 111(b)(2)(C).



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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice § 16.03

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§ 16.03 Shareholder Approval Requirements for Equity Compensation Plans

[1] NYSE Approval Requirements for Equity Compensation Plans

[a] NYSE General Requirement of Shareholder Approval for Equity Compensation Plans

In 2003, the SEC approved new SRO rules requiring shareholder approval of equity compensation plans.ⁿ¹ For NYSE-listed companies, "the Exchange requires that all equity-compensation plans, and any material revisions to the terms of such plans, be subject to shareholder approval, with ... limited exemptions"n2

The NYSE rules define an "equity-compensation plan" as "a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for service ... [including] a compensatory grant of options or other equity securities that is not made under a plan"n3

[b] Categories of Plans Not Considered Equity Compensation Plans Under the NYSE Rule

Two categories of plan are excepted from the definition of "equity-compensation plans" even if the brokerage and other costs of the plan are paid for by the listed company:n4

- plans made available to shareholders generally, such as a typical dividend reinvestment plan; and
- plans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, regardless of whether:
 - the shares are delivered immediately or on a deferred basis; or
 - the payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

[c] Material Revisions of Equity Compensation Plans Under the NYSE Rule

A "material revision" of an equity compensation plan is defined to include (but is not limited to), "a material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction)."⁵

If a plan contains a formula for automatic increases in the shares available or for automatic grants pursuant to a formula (a "Formula Plan"), each such increase or grant requires shareholder approval *unless* the plan has a term of not more than ten years.⁶ A shareholder-approved Formula Plan may be used if it is amended to provide for a term of not more than 10 years from its original adoption date or, if later, the date of its most recent shareholder approval. An amendment so limiting the term of the plan is not, in and of itself, a "material revision" requiring shareholder approval. In addition, a Formula Plan may continue to be used, without shareholder approval, if the grants made after June 30, 2003 are made *only* from the shares available immediately before the effective date--that is, are available due to formulaic increases that occurred before that date.

If a plan does not expressly limit the *number of shares available* (even if it limits the source of such shares, such as a provision that only treasury shares or repurchased shares are available for grant) and is not a Formula Plan (a "Discretionary Plan"), then each grant under the plan requires separate shareholder approval regardless of the term of the plan (that is, even if the term is less than 10 years).

Other material revisions requiring shareholder approval include:⁷

- an expansion of the types of awards available under the plan;
- a material expansion of the class of employees, directors or other service providers eligible to participate in the plan;
- a material extension of the term of the plan;
- a material change to the method of determining the strike price of options under the plan;
- the elimination or limitation of any provision prohibiting repricing of options.

An amendment also will be considered a "material revision" if it would increase the potential for shareholder dilution over the lifetime of the plan in question or would have an effect similar to the material revisions listed above. An amendment will not be considered a "material revision" if it curtails rather than expands the scope of the plan in question. In addition, an amendment that makes changes to the vesting schedule of awards under the plan will not be considered a "material revision."

[d] Options Repricings Under the NYSE Rule

The NYSE construes a plan that does not expressly permit repricing of options as prohibiting repricings.⁸ Therefore, any actual repricing of options under such a plan is considered a material revision of a plan even if the plan itself is not revised.

"Repricing" is defined broadly to mean any of the following or any other action that has the same effect:

- Reducing the strike price of an option after it is granted;
- any other action that is treated as a repricing under generally accepted accounting principles;

- canceling an "underwater" option (whose exercise price exceeds the fair market value of the underlying stock at the time the action is taken), in exchange for the issuance of another option, restricted stock, or other equity, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction.

[e] Exemptions from NYSE Shareholder Approval Requirement

[i] *General Rule Regarding Exemptions*

The NYSE recognizes three broad exemptions from the shareholder approval requirement, for:⁹

- employment inducement awards,
- certain grants, plans and amendments in the context of mergers and acquisitions, and
- grants under qualified plans, certain excess plans and IRS Section 423 plans.

Nevertheless, such awards, plans, grants and amendments are exempt from the shareholder approval requirements only if they are made with the approval of the company's independent compensation committee or the approval of a majority of the company's independent directors. NYSE-listed companies are also required to notify the Exchange in writing when they rely on one of these exemptions.¹⁰

[ii] *Employment Inducement Awards*

A grant of options or other equity-based compensation as a material inducement to someone being recruited for employment by the listed company or any of its subsidiaries (or "being rehired following a bona fide period of interruption of employment") is an employee inducement award that is exempt from the NYSE shareholder approval requirement.¹¹ This includes grants to new employees in connection with a merger or acquisition. Promptly after the making of any inducement award in reliance on this exemption, a NYSE-listed company is required to issue a press release, disclosing the material terms of the award, including the recipients of the award and the number of shares involved.¹²

[iii] *Mergers and Acquisitions*

In the context of mergers and acquisitions:

- shareholder approval is not required to convert, replace or adjust outstanding options or other equity-compensation awards to reflect the transaction; and
- without shareholder approval, companies may use shares of the listed entity to replace shares previously available under plans of acquired companies for grants to employees of the (no longer publicly listed) acquired company if that company otherwise had shares available for grant under pre-existing plans that were previously approved by shareholders, if
 - the number of shares available for grants is appropriately adjusted to reflect the transaction;
 - the time during which those shares are available is not extended beyond the period when they would otherwise have been available (absent the transaction) under the pre-existing plan; and

- the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction.

The NYSE will count any shares reserved for listing in connection with a transaction pursuant to either of these exemptions in determining whether the transaction (or a series of transactions of which it is a part) involved the issuance of 20 percent or more of the company's outstanding common stock (on a fully-diluted basis) before such issuance (either in voting power or in number of shares), thus requiring shareholder approval separately under NYSE Listed Company Manual Section 312.03(c).n13

[iv] *Qualified Plans, Parallel Excess Plans and Section 423 Plans*

Equity grants under certain types of employee plans entitled to special tax treatment under the IRC and excess plans designed to mirror such plans (and material revisions to any such plans) are exempt from the shareholder-approval requirements:n14

- plans intended to meet the requirements of *Section 401(a) of the IRC* (for example, qualifying Employee Stock Ownership Plans);
- plans intended to meet the requirements of *Section 423 of the IRC* (under which an employee may purchase no more than \$25,000 worth of stock annually at a discount of no more than 15 percent); and
- "parallel excess plans," meaning "Pension Plans" within the meaning of the Employee Retirement Income Security Act ("ERISA") that are designed to work in parallel with a plan intended to be qualified under *IRC Section 401(a)* to provide benefits that exceed the limits set forth in *IRC Section 402(g)* (the section that limits an employee's annual pre-tax contributions to a 401(k) plan), *IRC Section 401(a)(17)* (the section that limits the amount of an employee's compensation that can be taken into account for plan purposes), *IRC Section 415* (the section that limits the contributions and benefits under qualified plans) or any later-enacted successor or similar limitations, and
 - that covers all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit of *IRC Section 401(a)(17)* (or any successor or similar limits that may hereafter be enacted);
 - has terms that are substantially the same as the qualified plan that it parallels except for the elimination of the limits referred to above and the limitation set forth immediately below; and
 - under which no participant receives employer equity contributions in excess of 25 percent of the participant's cash compensation.

An equity compensation plan providing non-U.S. employees with substantially the same benefits as a comparable *IRC Section 401(a)* plan, *IRC Section 423* plan or parallel excess plan that the listed company provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, is also exempt from the shareholder approval requirements for NYSE-listed companies.

[2] NASDAQ Approval Requirements for Equity Compensation Plans

[a] NASDAQ General Requirement of Shareholder Approval for Equity Compensation Plans

NASDAQ-listed companies must require shareholder approval "when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which stock may be acquired by officers, directors, employees, or consultants"n15

[b] Exceptions to the NASDAQ Shareholder Approval Requirement

Under the NASD rules, there are four exceptions to shareholder approval requirement, for:n16

(i) warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of the company (such as a typical dividend reinvestment plan);

(ii) tax qualified, non-discriminatory employee benefit plans (such plans that meet the requirements of *Section 401(a) or 423 of the IRC*) or parallel nonqualified plans, provided such plans are approved by the issuer's independent compensation committee or a majority of the issuer's independent directors; or plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value; or

(iii) plans or arrangements relating to acquisitions or mergers in two situations:

- the conversion, replacement or adjustment of outstanding options or other equity compensation awards to reflect the transaction, or

- the use, for post-transaction grants, of shares available for grant under pre-existing plans of the (acquired) company (which is no longer listed after the transaction), by converting those shares into the dollar-equivalent number of shares of the (still listed) acquiror, provided that:n17

- the time during which those shares are available for grant is not extended beyond the period when they would otherwise have been available for grant, absent the transaction; and

- such options or other awards are not granted to persons employed by the (still listed) acquiror or its subsidiaries at the time immediately preceding the closing of the merger or acquisition (as opposed to officers or employees of the acquired company, which is no longer listed after the transaction); and

(iv) inducement awards, meaning options or stock issued to recruit new employees or directors, or to attract a former employee or director to return to the company after a bona fide period of non-employment, provided that such awards are approved by either the issuer's independent compensation committee or a majority of the issuer's independent directors. Promptly after making any inducement award in reliance on this exception, a company must disclose in a press release the material terms of the grant, including the recipients of the grant and the number of shares involved.

[3] Practical Implications of Shareholder Approval Requirements

The major practical implication of the 2003 SRO shareholder approval requirements for equity-based compensation plans should be to cause companies to adopt omnibus equity-based plans that are as broad and flexible as possible. Because, in general, the adoption or material amendment of equity compensation plans for listed companies now requires shareholder approval, as a matter of convenience companies will want to adopt plans that give them wide leeway, once approved by shareholders, to vary the terms of grants from year to year, as competitive conditions and

other business considerations may require, without having to go back to the shareholders for approval each time. Companies will be well-advised to go to the limits of flexibility and inclusiveness in equity-based compensation plans submitted to shareholders, constrained only by "best practices" principles and guidelines of major institutional shareholders.ⁿ¹⁸

Companies also should consider the effect that the positions of proxy advisory firms (such as RiskMetrics Group (formerly Institutional Shareholder Services) and Glass Lewis) and institutional shareholders (such as Fidelity and CalPERS) may have on shareholder approval of equity-based compensation plans. If the terms of the proposed plan do not fall within their voting guidelines, they may vote against or recommend voting against the proposed plan. *See Section 16.05* of this chapter for a discussion of RiskMetrics Group's voting policies with respect to equity-based compensation plans.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate LawCorporationsShareholders

FOOTNOTES:

(n1)Footnote 1. *See* SEC Release No. 34-48108 (June 30, 2003), *available at* www.sec.gov/rules/sro/34-48108.htm.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.08 This rule supplanted a previous NYSE rule requiring shareholder approval of stock option plans authorizing grants to officers and directors, but exempting "broadly based stock option plans" from this shareholder approval requirement. A plan was considered to be "broadly based" if (i) at least a majority of the company's full-time employees in the U.S. were eligible to receive grants of stock options and (ii) at least a majority of the shares underlying options granted under the plan were awarded to employees who are not officers or directors of the company. *See* SEC Release No. 34-41479 (June 4, 1999), *64 Fed. Reg. 31677 (June 24, 1999)*; SEC Release No. 34-47409 (Feb. 26, 2003), *68 Fed. Reg. 10560 (Mar. 5, 2003)*. Section 303A.00, Corporate Governance Standards, of the NYSE Listed Company Manual is reproduced in Appendix B to this treatise.

(n3)Footnote 3. NYSE Listed Company Manual § 303A.08.

(n4)Footnote 4. NYSE Listed Company Manual § 303A.08.

(n5)Footnote 5. NYSE Listed Company Manual § 303A.08.

(n6)Footnote 6. The rule gives two examples of automatic grants pursuant to a formula plan: (1) annual restricted stock grants to directors having a certain dollar value; and (2) "matching contributions," under which stock is credited to a participant's account according to the amount of compensation the participant elects to defer.

(n7)Footnote 7. NYSE Listed Company Manual § 303A.08.

(n8)Footnote 8. NYSE Listed Company Manual § 303A.08.

(n9)Footnote 9. NYSE Listed Company Manual § 303A.08.

(n10)Footnote 10. NYSE Listed Company Manual § 303A.08.

(n11)Footnote 11. NYSE Listed Company Manual § 303A.08.

(n12)Footnote 12. NYSE Listed Company Manual § 303A.08.

(n13)Footnote 13. NYSE Listed Company Manual § 303A.08. Note, however, that there are four exemptions from the shareholder approval requirement for the issuance of 20 percent or more of the pre-existing equity, for the details of

which boards or board counselors dealing with a 20-percent-or-more situation should review NYSE Listed Company Manual Section 312.03(c).

(n14)Footnote 14. NYSE Listed Company Manual § 303A.08.

(n15)Footnote 15. NASDAQ Rule 4350(i)(1)(A). NASDAQ Rule 4350 is reproduced in Appendix C to this treatise.

(n16)Footnote 16. NASDAQ Rule 4350(i)(1)(A)(i).

(n17)Footnote 17. NASDAQ Interpretation Material (IM) 4350-5. IM 4350-5 is reproduced in Appendix C to this treatise.

(n18)Footnote 18. *See* discussion of best practice guidelines in § 16.05 below.



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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice § 16.04

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§ 16.04 Recoupment of Incentive Compensation

[1] Sarbanes-Oxley Section 304 (Forfeiture of Certain Bonuses)

Under Sarbanes-Oxley Section 304n1

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--

- (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
- (2) any profits realized from the sale of securities of the issuer during that 12-month period.

Not every restatement results in the obligation for the CEO and CFO to reimburse the company for bonuses and profits. It must be a restatement "due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirements under the securities laws" The law does not specify what level of misconduct or whose misconduct is required to trigger the reimbursement obligation.n2

Nevertheless, it is clear from the wording of the statute that when material noncompliance as a result of misconduct leads to a restatement, the obligation to reimburse the bonuses and profits received during the specified period (the 12-month period following the first public issuance or filing with the SEC of the financial statement that was later restated) is absolute. The law does not require any showing of causation (that the initial inclusion of information that was later restated actually resulted in the payment of the bonus or the realization of the profits for which the CEO and CFO are required to reimburse the company).

[2] Best Practices

Following the Enron- and WorldCom-era corporate scandals and enactment of Sarbanes-Oxley Section 304, there has been increased attention on the extent to which companies have the ability to recoup--or "clawback"--incentive compensation awarded to senior executives if it is later determined that their activities significantly contributed to a financial statement restatement, which resulted in a determination that the executives had received unearned incentive compensation as a direct result of their own misconduct.

Clawback provisions have been a focus of shareholder proposals in recent years. Between January 2004 and June 2008, shareholders submitted a total of 32 proposals requesting that companies adopt clawback provisions, including six proposals submitted for the 2008 proxy season. The 32 shareholder proposals were submitted to 22 different companies, with some companies receiving the proposal in more than one year. Of these 22 companies, nine previously had restated their financial results in the one to five years before receiving the proposal. The popularity of clawback shareholder proposals peaked in 2006 and 2007, when shareholders submitted ten and 11 proposals, respectively.

Some companies have taken steps to address clawbacks in response to a shareholder proposal, and some have done so as a general governance reform or following a high-profile restatement of financial results. A survey of approximately 2,100 companies released in June 2008 by The Corporate Library found that 300 companies had clawback provisions, compared to only 14 companies that had disclosed the existence of these provisions four years ago. As of March 2008, 28 of the Dow 30 companies had implemented clawback provisions, including 23 companies that had adopted formal clawback policies aimed at recouping the incentive compensation paid or granted to executive officers and certain other employees. These policies most often provide for recoupment in the event of a restatement or a significant/material restatement of financial results due to misconduct on the part of the executive officer or other employee. The remaining five companies had incentive compensation plans that contain clawback provisions.

Companies should consider several issues when addressing clawbacks. The primary question for companies to consider is whether to address clawbacks in the first place. Doing so sends a message to shareholders that the board is committed to sound executive compensation practices and effective corporate governance, and voluntary implementation of clawback provisions will reduce the likelihood that a company will receive a shareholder proposal. On the other hand, companies need to consider whether the adoption of a clawback will adversely affect their ability to attract and retain executives. Once a company decides to adopt a clawback provision, the following issues should be addressed in formulating the provision:

- To whom should the clawback provisions apply? Clawback provisions can cover the CEO and CFO, or they can apply more broadly to all executive officers or even all employees. Covering the CEO and CFO is consistent with the approach taken in Sarbanes-Oxley Section 304. However, a clawback provision that is limited in this respect does not reach other executive officers whose compensation may be performance-based or whose job functions may affect a company's financial reporting. Proxy voting advisors RiskMetrics Group and Glass Lewis generally favor clawback shareholder proposals covering executive officers and recommend that shareholders vote "for" proposals seeking recoupment from both senior executives and employees who are potentially responsible for accounting improprieties.
- To which awards should clawback provisions apply? Base salary is not generally linked to specific performance targets and, therefore, is not typically covered by clawback provisions. With respect to performance-based awards, the single most popular approach that companies have taken is to adopt clawback provisions that include all performance-based awards, both short-term (*i.e.*, with a performance period of one year or less) and long-term (*i.e.*, with a performance period of more than one year, and typically two to four years).
- What circumstances should trigger clawback provisions? Companies with clawback provisions take a variety of approaches to the standards for determining the circumstances that trigger these provisions. Clawback provisions can apply in the event of a "significant" or "material" restatement, in the event of

all restatements (other than those due to changes in accounting policy) or in the event that financial data turns out to be incorrect. Many companies have limited the application of their clawback provisions to "significant" or "material" restatements.

- To what type of conduct should the clawback provisions apply? Alternatives include requiring recoupment in the event of misconduct by the executive officer from whom recoupment is sought, in the event of misconduct by any employee, or in the event of any conduct that results in incorrect financial data. Limiting clawback provisions to misconduct by the individual executive officers from whom a company seeks recoupment is the most common alternative and provides a targeted approach that incorporates a deterrent effect. Broader provisions that rely on misconduct by any employee could be viewed as consistent with the oversight function performed by senior executives. Finally, a "no-fault" clawback provision would not require any misconduct; instead, it would mandate recoupment simply upon a restatement of financial statements or the discovery of incorrect financial data.

- Should the clawback provisions grant discretion to the board? Clawback provisions may grant discretion to the board of directors to determine whether misconduct occurred and whether to recoup compensation. Provisions that grant discretion to the board offer the advantage of flexibility because the board can decide whether, and to what extent, recoupment is appropriate based on the specific facts and circumstances involved. However, if the board has too much discretion, RiskMetrics Group may recommend a vote in favor of a clawback shareholder proposal where a company's clawback provisions grant what RiskMetrics Group views as too much discretion to the board.

- To what extent should the clawback provisions modify employment agreements, compensation plans and award agreements? The adoption of a clawback policy, without more, may raise questions as to the policy's enforceability and could lead to criticism for failing to implement the provisions fully. Accordingly, companies should consider the additional step of amending existing employment agreements, compensation plans and/or award agreements to include specific reference to clawback provisions, either by adding language that provides for recoupment in specified circumstances or by incorporating an external clawback policy by reference.

- How far back should the clawback provisions reach? Consistent with Sarbanes-Oxley Section 304, some companies have adopted clawback provisions that reach back 12 months prior to the filing of restated financial results. However, more companies have adopted provisions that reach back for longer periods. In some cases, the relevant period covers 36 months, representing the period of time for which companies must include financial statements in their SEC filings, while other companies' provisions reach back for longer periods, such as five years, or correspond to the length of performance cycles (often three years) under compensation plans.

[3] Emergency Economic Stabilization Act of 2008

The recently enacted Emergency Economic Stabilization Act of 2008 contains a clawback provision among other executive compensation requirements. Senior executive officers of TARP recipients must pay back any bonus or incentive compensation paid to them that was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.³ For companies subject to EESA, this provision is broader than Sarbanes-Oxley Section 304 in that it applies to the top five highest paid officers (as opposed to just the CEO and CFO), is triggered by any materially inaccurate financial statement or performance metric (as opposed to an accounting restatement), does not require misconduct, and is not limited to a 12-month look-back period. ARRA amended EESA to expand the scope of this prohibition, as discussed in *Section 16.06* of this chapter.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Governing Documents & Procedures Records & Inspection
Rights Recordkeeping

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 7243*.

(n2)Footnote 2. For example, it seems unlikely that simple negligence would rise to the level of "misconduct" required to trigger this obligation. Would gross negligence or recklessness--for example, in certifying periodic financial statements under the Sarbanes-Oxley Section 302 without having undertaken proper due diligence to ensure that accuracy of the certification--trigger the reimbursement obligation, or is some higher level of scienter, akin to intention to defraud, required? No case, regulation or administrative decision has addressed this issue as of the time of this writing.

(n3)Footnote 3. *EESA § 111(b)(2)(B)*.



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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice § 16.05

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§ 16.05 Corporate Governance "Best Practice Guidelines" on Executive Compensation

[1] Proliferation and Importance of Executive Compensation Best Practices

Many of the corporate governance scandals of the late 1990s and early 21st century (such as ENRON, WorldCom, and Tyco) involved not only accounting irregularities and fraud but excessive executive compensation. In many of these cases, investigators found that the motivation for improperly inflating reported earnings was to enrich senior corporate executives, most often the CEO. In other cases (most notably, the \$188 million pay package of Richard Grasso, former chairman of the New York Stock Exchange), exorbitant executive compensation, in and of itself, has become a cause celebre, even when there was no suggestion of underlying fraud or accounting irregularities.

Largely as a result of these scandals, and the public attention they drew, and also because executive compensation is perhaps the most basic corporate governance issue (in that it involves a direct conflict between the personal financial interests of the company's senior executives, who influence compensation decisions, including their own, on the one hand; and the interests of the company and its shareholders, on the other hand), influential shareholder advocacy groups, institutional investors, and other organizations with an interest in corporate governance have published new or updated "best practices" guidelines for executive compensation. While such guidelines often take note of the competitive market for senior executive talent and the importance for maximizing overall shareholder value of attracting and retaining such talent, by and large they aim to restrain what their authors perceived as excesses and abuses in executive compensation.

Among the most influential "best practices" guidelines for executive compensation that have been published by broad-based business groups are the November 2003 Business Roundtable report, "Executive Compensation: Principles and Commentary," which is reproduced as Appendix 15-A to the preceding chapter of this work, and the 2003 report of the Blue Ribbon Commission of the National Association of Corporate Directors (the "NACD"). The Executive Summary of the "Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee" is reproduced as Appendix 16-B to this chapter, and a section from that report providing guidance on executive employment contracts (including change-of-control contracts) is reproduced as Appendix 16-C to this chapter. Among the most comprehensive executive compensation guidelines published by institutional shareholders is the TIAA-CREF Policy Statement on Corporate Governance--Executive Compensation and Appendix. This

document is reproduced in full as Appendix 16-D to this chapter.

Among the recommendations common to most such best-practices guidelines are principles relating to the functioning and independence of board compensation committees.ⁿ¹ In general, these recommendations emphasize:

- rigorous committee independence;
- ongoing training of compensation committee members in executive compensation issues;
- an annual assessment of the performance of the compensation committee;
- the compensation committee's direct retention and control of its own experts, including legal counsel and compensation consultants, as appropriate;
- the importance of the compensation committee's taking the time and receiving the information to comprehend, both generally and in detail, the amounts payable, especially to senior executive officers, under all compensation programs in effect, and the cost to the company of such programs; and
- complete transparency and full disclosure to the board as a whole and to the company's shareholders of both the details and the overall expense of such compensation programs.

The following discussion will focus on substantive "best practice" recommendations relating to certain executive compensation issues.

[2] Specific Best Practice Recommendations

[a] Pay-for-Performance

A consistent theme of the compensation best-practices recommendations that emerged early in the 21st century was an increased emphasis on pay-for-performance for the CEO and other senior executives. For example, the NYSE corporate governance listing standards expressly require the independent compensation committee to have a written charter requiring the committee to "review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level *based on this evaluation*."ⁿ² While the commentary to that section makes it clear that the compensation committee may also consider market factors ("the value of similar incentive awards to CEOs at comparable companies"), the emphasis of the required charter provision is clearly on performance-based compensation for the CEO. Virtually all other major best-practices recommendations on executive compensation stress the importance of performance-based compensation, as well.ⁿ³

In addition, the recent financial crisis has heightened public scrutiny of compensation that is not tied to company performance. For example, in response to the \$165 million in retention bonuses paid to AIG executives after the federal government bailed out the company, lawmakers introduced legislation to curb these practices. House Resolution 1586, passed in the U.S. House of Representatives on March 19, 2009, imposes a 90-percent tax on the lesser of the amounts of bonuses and the amounts by which an employee's annual adjusted gross income exceeds \$250,000 (or \$125,000 if married and filing jointly) at TARP recipients that receive in excess of \$5 billion in government funds. Senate Bill 652, introduced on March 19, 2009, imposes a 70% tax on any bonus exceeding \$50,000 at TARP recipients that receive in excess of \$100 million.

In line with this trend, in early 2004 RiskMetrics Group (formerly Institutional Shareholder Services ("ISS") ("RMG")), the proxy advisory organization, added a "pay-for-performance" overlay to its proprietary quantitative model for

determining whether to recommend that its clients vote for or against proposed equity-based compensation plans. Its quantitative model calculates a maximum allowable cap for equity-based compensation plans, taking a number of factors into account. If the potential cost (including shareholder value transfer) of the proposed plan, when combined with existing plans, exceeds the cap, or if the proposed plan violates RMG repricing guidelines (expressly allowing repricing of underwater stock options or stock appreciation rights without shareholder approval), RMG will recommend a vote against the adoption of the proposed plan. Even if these tests are met, as of 2009, RMG will recommend a vote against a proposed equity-based compensation plan if:

- the CEO is a participant in the proposed plan and there is a disconnect between CEO pay and the company's performance, meaning there is an increase in the CEO's total compensation (defined as the sum of base salary, bonus, non-equity incentives, grant date full value of stock awards and options, target value of performance shares/units, change in pension value and nonqualified deferred compensation earnings, and all other compensation) from the prior year while the company's one-year and three-year total shareholder returns are in the bottom half of its industry group, and 50% of such increase in compensation is attributed to equity awards;
- the company's three-year burn rate exceeds the greater of 2% and the mean plus one standard deviation of its industry group;
- the plan provides for the acceleration of vesting of equity awards even though an actual change in control may not occur (*e.g.*, upon shareholder approval of a transaction or the announcement of a tender offer); or
- the plan is a vehicle for poor pay practices.ⁿ⁴

There are two major policy rationales for the increased emphasis on pay-for-performance. The first is the obvious goal of solving the so-called agency problem--the divergence of interest between professional managers who control corporate resources and the owners of modern corporations (shareholders with no day-to-day involvement in the business) who do not. The second policy rationale is to provide an anchor to restrain continuous increases in executive compensation, against a background of criticism that compensation committees had increased executive (especially CEO) compensation beyond reasonable bounds in part by reason of their over-reliance on surveys, combined with a policy of paying CEOs above (sometimes significantly above) the mid-point, leading to a continual increase in the mid-point shown in each successive year's survey and unrestrained inflation in CEO compensation.ⁿ⁵

In addition, a "disconnect" between performance and CEO pay will "generally" warrant a "withhold" or an "against" vote for compensation committee members, under RMG's 2004 guidelines.ⁿ⁶ As of 2009, RMG also will recommend "withhold" or "against" votes for compensation committee members, the CEO and potentially the entire board if the company has "poor compensation practices," including, but not limited to:

- egregious employment contracts, meaning contracts providing for multi-year guarantees of salary increases, bonuses and equity compensation;
- excessive perquisites, including personal use of corporate aircraft, personal security systems and car allowances, tax reimbursements, including reimbursement of income taxes on executive perquisites or other payments, or perquisites for former executives;
- abnormally large bonus payouts, including changing, canceling or replacing performance metrics during the applicable performance period, without linking such payouts to performance or properly disclosing such payouts;

- egregious pension or supplemental executive retirement plan payouts, including taking into account years of service not worked and incorporating performance-based equity awards into the pension calculation;
- overly generous new hire packages for a CEO;
- excessive severance or change in control provisions, including severance or change in control payments with a multiple in excess of 3x cash compensation, payments upon termination due to a performance failure, single-trigger change in control payouts, and new or materially amended employment or severance agreements that provide for modified single triggers (meaning an executive may resign for any reason and still receive the change in control or severance package) or an excise tax gross-up, and a liberal change in control definition;
- dividends or dividend equivalents paid on unvested performance shares/units;
- poor disclosure practices, including not clearly explaining how the CEO is involved in setting pay, not discussing retrospective performance targets or methodology, and not discussing the methodology for benchmarking or explaining the peer group;
- internal pay disparity, including an excessive differential between the total compensation of the CEO and the next highest paid named executive officer;
- options backdating.

In light of increased shareholder activism and the increased number of companies that have adopted majority voting for director elections in recent years, RMG voting recommendations continue to have a greater impact on the ability of directors to be re-elected.

Under the 2007 revisions, which have not changed, of its voting policy guidelines, RMG generally recommends that its clients vote for shareholder proposals advocating the use of performance-based awards (such as contingent options or restricted stock, indexed options or premium priced options) unless (a) they are overly restrictive or (b) the company demonstrates that a substantial proportion (50 percent or more) of shares awarded to top executives (the five most highly compensated) for the most recent fiscal year are already performance-based. RMG does not consider standard at-the-money stock options or performance-accelerated restricted stock awards to be performance-based and, for premium options to be considered performance-based, RMG requires at least a 25-percent premium. In addition, where the shareholder proposal requests that a significant amount of future long-term incentive compensation awarded to senior executives be performance-based and that the board adopt and disclose to shareholders challenging performance-based metrics, RMG assesses the rigor of the company's performance-based equity program and, if (a) it determines that the company has set the bar too low (in view of the company's history or peer-group comparison), (b) target performance results in an above-target payout, or (c) the company does not disclose the performance metric of the performance-based equity program, RMG will generally support the shareholder proposal.ⁿ⁷

[b] Stock Ownership Guidelines

Many companies have adopted, and many corporate watchdog groups and other commentators have recommended, stock ownership guidelines requiring or encouraging directors and senior corporate officers to own certain levels of company stock, typically increasing over time to a minimum level (expressed as a multiple of the individual executive's salary or the director's annual fees) that he or she should hold.ⁿ⁸ For example, General Electric Company, a leader in corporate governance, has established the following ownership guidelines (with the "multiple" being a multiple of base salary) for senior executives:ⁿ⁹

Position	Multiple	Time to Attain
CEO	6X	3 years
Vice Chair	5X	4 years
Senior VPs	4X	5 years

The establishment and publication of such stock ownership guidelines raise the question of enforcement. For the most part, companies seem to rely on "moral suasion" in the form of a periodic review (by the compensation committee, the corporate governance and nominating committee, the chairman or the chief executive officer) of where covered executives' stock ownership stands as against established guidelines and the publication in the annual proxy statement (and, sometimes, on the company's web site) of the stock ownership guidelines and a statement as to whether all covered executives and directors are in compliance with those guidelines.

The NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee recommends that the compensation committee "[r]equire executives to purchase at least some stock on their own, rather than receiving all their stock awards as pay over and above their base salary."¹⁰ Nevertheless, any requirement that executives purchase company stock with their own funds has not become a standard practice as of the time of this writing.

[c] Equity-Based Compensation

[i] *Use of Stock Options and Restricted Stock, Generally*

As discussed at length in Chapter 15 *above*, opinion of shareholder watchdog groups and other commentators has varied, from time to time, about the appropriateness and utility of stock options and other forms of equity-based compensation (such as restricted stock and phantom stock options or stock appreciation rights) as a means of tying managers' financial incentives to stockholder interests.¹¹ Even in the wake of perceived abuses and excesses in some corporate stock option programs, few corporate governance advocacy groups have come out against the use of stock options, subject to appropriate guidelines, as one form of equity-based compensation that can help to align manager's financial interests with those of shareholders. Nevertheless, TIAA-CREF, a major pension fund and annuity investor and a significant voice in matters of corporate governance, has amended its Policy Statement on Corporate Governance to state that "equity-based plans should emphasize restricted stock awards ... [because r]estricted stock more closely aligns the interests of executives with shareholders (as opposed to option grants)" and that "[e]quity-based plans should make judicious use of stock option grants."¹² The Council of Institutional Investors has adopted guidelines that suggest that companies should utilize a multitude of "long-term incentive vehicles to achieve a variety of long-term objectives, including performance-based restricted stock/units, phantom shares, stock units and stock options."¹³

[ii] *Specific Guidelines for Equity-Based Compensation*

[A] "Mega-grants"

Corporate governance guidelines have cautioned against grants of stock options or restricted stock in amounts grossly disproportionate to base pay or otherwise so large in amount that they are difficult to explain sensibly to the investing public (popularly known as "mega-grants").¹⁴

[B] Repricing and Discount Options

Repricing or replacement of underwater stock options without shareholder approval was a practice that some companies employed in the nineteen nineties and early part of the 21st century, particularly after the technology stock price "bubble" burst. Today, not only do corporate governance best-practices guidelines dealing with executive compensation

admonish companies not to reprice or replace out-of-the-money stock options without shareholder approval¹⁵; SRO corporate governance listing requirements specifically provide that shareholder-approved equity-compensation plans that do not specifically permit repricing are construed to prohibit repricing, and therefore any actual repricing is considered a material revision of such a plan, requiring shareholder approval.¹⁶ In addition, RMG will recommend that its clients vote against any proposed plan that permits repricing without shareholder approval.

[C] Performance Vesting

Corporate governance best-practices guidelines encourage performance vesting for restricted stock and even for stock options.¹⁷ While the intrinsic value of at-the-money or premium stock options is inherently tied to corporate performance (in that they have no cash value unless the value of the underlying stock appreciates to a point in excess of the exercise price), stock options without features tying vesting or exercisability to company performance as against an appropriate industry or peer-group index ("Indexed Options") have been criticized for their potential to confer windfall benefits on their recipients.¹⁸ Nevertheless, some compensation experts have criticized Indexed Options as well, as being inefficient or otherwise inappropriate for a variety of reasons, and have therefore predicted that they are unlikely to come into common use.¹⁹ More companies seem to be granting restricted shares whose vesting or exercisability is tied to objective measures of corporate performance.²⁰

[D] Holding Periods and Retention Requirements

Modern corporate governance guidelines on best practices in the area of executive compensation often recommend that executives be required to hold stock purchased on exercise of stock options (or awarded as restricted stock) for specified periods of time.²¹ Such requirements may take one of two forms--specifying either (a) the minimum period (often one year) beyond the time of exercise of stock options that senior executives should hold the stock they acquired (often with the exception of stock sold to pay taxes or to pay the cost of exercising stock options); or (b) the minimum percentage of stock (such as 50 percent, for senior executives) acquired through stock option exercises and restricted stock awards that such officers should hold during their continued tenure with the company. These requirements have garnered increased attention in the wake of the financial crisis and increased investor focus on the relationship between risk and compensation policies. During the 2009 proxy season, shareholders submitted a new proposal calling for companies that received TARP assistance as well as other companies to require their executives to hold stock acquired through equity awards for two years past retirement, and some companies announced their intention to adopt these kinds of policies. In a speech on June 10, 2009, Treasury Secretary Tim Geithner outlined principles to guide executive compensation reform, which included, among other things, aligning compensation with the time horizon of risks by requiring executives to hold stock for longer periods of time.²²

[E] Timing and Dating of Option Grants

In the wake of the executive stock option scandal that erupted in 2006²³, public companies came under pressure to adopt and disclose policies regarding the timing and dating of executive stock options.²⁴ Commentators and law firms have suggested model policies in this area, and many public companies have adopted and disclosed such policies.

A common denominator of most such policies is that executive options are priced on the date on which they are granted, often at the closing price on that day on the principal stock exchange on which the company's shares are traded. In addition, many commentators have recommended - and many companies have adopted - policies providing for annual grants of executive stock options to be made on the same day (or at the time of the same annual event, such as, for example, on the date in April of the meeting of the company's board of directors) each year. While some commentators have suggested that stock option grants not be made at a time when the company has material inside information, others have pointed out that, if the grant date is pre-determined, it should not be necessary to preclude grants at a time when the company is in possession of such information (and, moreover, a company's flexibility to change the grant date on that basis would risk signaling to the market that such information exists, since annual option grants are often made to a

large number of employee and, therefore, the normal and expected grant date is virtually public knowledge in large companies).

Some commentators have suggested that companies require all grants to be approved by the compensation committee of the board of directors. Nevertheless, to preserve flexibility, many companies have adopted policies allowing off-cycle grants (used, for example, as inducement awards for new recruits or as in settlements with employees whose employment is terminated without cause) to be made by a senior officer (such as the CEO) and to be granted and priced on a specified date following the event (for example, at the closing price on the first Monday of the month following the new employee's first date of employment).

[3] Employment and Change-in-Control Contracts

Some corporate governance best practices guidelines deal with employment agreements and change-in-control provisions. In connection with executive employment agreements generally, for example, the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee recommends, among other things:²⁵

- Not treating non-renewal of a contract as an automatic trigger for severance pay.
- Not extending severance benefits beyond the executive's age 65 or the company's normal retirement date.
- Not adding years to an executive's years of employment in order to increase the executive's retirement package.
- Not continuing to pay active-employment benefits to executives who elect retirement during a severance period in order to start drawing a pension.
- Before agreeing to an employment agreement, reviewing company costs under a "worst case" severance benefit.
- In the definition of "for cause" termination including violations of the company's code of business conduct and ethics, as well as violations of its insider-trading policies.²⁶
- Conditioning severance payments on the executive's agreement to standard "no compete, no raid, no sue, no tell" provisions.
- Not extending special retirement benefits to CEOs of short tenure and undistinguished performance; and making any extension of special benefits to a long-serving and honored CEO relatively short in duration.

In connection with change-in-control agreements, many corporate governance groups advocate against the use of "single trigger" severance provisions (that is, provisions under which payments are triggered merely by a change in control of the employing company, regardless of whether the company then terminates the executive's employment or reduces the executive's compensation, benefits or scope of responsibilities).²⁷ Also, in connection with change-in-control provisions, the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee recommends, among other things:²⁸

- Not automatically accelerating vesting of stock options or equity grants (but, rather, doing so only upon a change of control in cases of cash buyouts, where there is no equity conversion for shareholders,

or upon an involuntary termination of employment (not for cause) following a change of control).

- Periodically reviewing total company costs for severance benefits in case of a change of control, and comparing such costs to the company's total equity market capitalization.

Some institutional shareholders generally support shareholder proposals to require shareholder approval for golden parachute severance arrangements that exceed IRS guidelines and consider, on a case-by-case basis, all shareholder proposals to require approval of golden parachute arrangements.ⁿ²⁹

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate Law Corporations Directors & Officers Compensation

FOOTNOTES:

(n1)Footnote 1. These are discussed in detail in Chapter 10 *above*.

(n2)Footnote 2. NYSE Listed Company Manual § 303A.05(b)(i) (emphasis added).

(n3)Footnote 3. *See, e.g.*, NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at 4, 12, 22 (2003), *see* Appendix 16-B *below*; Business Roundtable, Executive Compensation: Principles and Commentary at 1-3 (Nov. 2003) ("A meaningful portion of executive compensation should be performance-based, thereby incorporating a greater element of downside risk into compensation arrangements."), reproduced in Appendix 15-A to Chapter 15 *above*; TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, at 16-17, §§ A. 5-6 *available at* www.tiaa-cref.org/pubs/pdf/governance_policy.pdf ("Compensation plans should be objectively linked to appropriate parameters of company performance ..."), *see* Appendix 16-D *below*.

(n4)Footnote 4. *See* RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines Summary at pp. 32-38, *available at* <http://www.riskmetrics.com/sites/default/files/RMG2009SummaryGuidelinesUnitedStates.pdf>.

(n5)Footnote 5. *See, e.g.*, NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at 13 (2003) ("The tendency of some compensation committees to pay at the 75th percentile has led to upward ratcheting of pay that is not always justified by individual or company performance, and that does not always consider the company's financial circumstances.").

(n6)Footnote 6. In 2004, because of the perceived existence of such a "disconnect," RMG recommended withhold votes at 24 companies and issued cautionary statements at an additional 242 companies; in 2005, RMG issued withhold recommendations at 70 companies on such grounds. *See* CEO Perspective - Special Edition, <http://www.issproxy.com/about/ceoarchive/0406ceomessage.jsp>.

(n7)Footnote 7. RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines Summary at p. 46, *available at* <http://www.riskmetrics.com/sites/default/files/RMG2009SummaryGuidelinesUnitedStates.pdf>.

(n8)Footnote 8. *See, e.g.*, Business Roundtable, Executive Compensation: Principles and Commentary, Commentary on Principle 4, at 8 (Nov. 2003) ("Stock ownership guidelines are increasingly being used by compensation committees to align executive compensation with the long-term interests of stockholders. The compensation committee should establish requirements that senior management, and members of the board of directors, acquire and hold a meaningful amount of the corporation's stock."); NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at 20 (2003) (recommending that, "[t]o ensure that managers have a stake in the long-term performance of the company, compensation packages should include incentives to buy or own stock and disincentives to sell it" and that, to achieve this goal, compensation

committees should consider setting guidelines for minimal ownership of stock as some multiple of salary).

(n9)Footnote 9. *See* General Electric Company, Management Compensation and Development Committee: Key Practices, § 4, *available at* http://www.ge.com/pdf/company/governance/board/mngment_dev_key_practices08.pdf

(n10)Footnote 10. NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at 26 (2003).

(n11)Footnote 11. *See* § 15.03 above.

(n12)Footnote 12. TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, at 18, §§ A. 4-5, *available at* www.tiaa-cref.org/pubs/pdf/governance_policy.pdf and reproduced in Appendix 16-D to this chapter.

(n13)Footnote 13. Council of Institutional Investors, Corporate Governance Policies *available at* <http://www.cii.org/UserFiles/file/council%20policies/CII%20Full%20Corp%20Gov%20Policies%205-7-09.pdf>.

(n14)Footnote 14. *See, e.g.*, TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, Equity-Based Compensation, at 18, § A. 6, *available at* www.tiaa-cref.org/pubs/pdf/governance_policy.pdf and reproduced in Appendix 16-D to this chapter ("Equity-based plans should specifically prohibit or severely restrict 'mega grants,' which are grants or stock options of a value, at the time of grant, greater than a reasonable and explainable multiple of the recipient's total cash compensation.").

(n15)Footnote 15. *See, e.g.*, Council of Institutional Investors, Council Policies--Director and Management Compensation, *available at* www.cii.org/dcwascii/web.nsf/doc/policies_iv.cm ("Unless submitted to shareholders for approval, no 'underwater' options should be repriced or replaced and no discount options should be awarded.").

(n16)Footnote 16. NYSE Listed Company Manual § 303A.08.

(n17)Footnote 17. *See, e.g.*, TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, Equity-Based Compensation, at 18, § A. 5, *available at* www.tiaa-cref.org/pubs/pdf/governance_policy.pdf and reproduced in Appendix 16-D to this chapter ("When stock options are awarded, a company should develop plans for performance-based options, which set performance hurdles to achieve vesting; premium options, with vesting dependent on attainment of a pre-determined appreciation of stock; and/or indexed options, with a strike price tied to an index"); Business Roundtable, Executive Compensation: Principles and Commentary, Commentary on Principle 1, at 4 (Nov. 2003) ("Although restricted stock can be an effective retention device, it is more effective as a long-term incentive if it vests based on the achievement of specified performance targets.").

(n18)Footnote 18. *See, e.g.*, S. Burchman & B. Jones, *The Future of Stock Options*, 13 *WorldAtWork J.* 29 (Jan. 1, 2004); N. Darwish, E. Brewer & D. Evanoff, *Corporate Governance: Implications for Financial Services Firms*, Chicago Fed Letter at 1 (Dec. 1, 2003)(quoting Chicago Federal Reserve Bank President Michael H. Moskow as saying, "Because these options were not indexed to the market, this led to enormous--and let me say quite unexpected--increases in the wealth of some executives. And many of them reaped these windfalls even though the price of their firms' stock had underperformed those of their peers ...").

(n19)Footnote 19. *See, e.g.*, R. Grams, *Consequences of Executive Stock Options Ownership*, 12 *WorldAtWork J.* 55 (July 1, 2003) ("Premium stock options or indexed stock options should be used rarely, if at all. Some respected practitioners recommend using premium options (exercise price higher than the market value at the time of grant) or indexed options (exercise price based on comparison group stock price changes) to enhance the connection between performance and pay and to avoid compensation windfalls.

Such options would encourage a level of risk taking even greater than the case for normal stock options. Moreover,

they would be very inefficient in terms of perceived value to the executive as compared to the opportunity cost for the business. Lastly, the low value inefficiency combined with relatively low Black-Scholes values means that premium and indexed options would require much larger grant sizes than normal options to achieve the same psychological value. As a result, they are unlikely to become common."); F. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 *Del. J. Corp. L.* 129 at 171-172 (2003); see also L. Bebchuck, J. Fried & D. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chi. L. Rev.* 751 at 801-802 (2002) (noting the rarity of indexed options).

(n20)Footnote 20. "Hewitt Study Shows Companies Revamping Long-Term Executive Incentive Programs," available at www4.hewitt.com/hewitt/resource/newsroom/pressrel/2004/04-08-04.htm (Apr. 8, 2004) (reporting that 38 percent of 150 large U.S. companies surveyed are converting options into performance-based shares").

(n21)Footnote 21. See, e.g., TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, Equity-Based Compensation, at 18, § A. 5, available at www.tiaa-cref.org/pubs/pdf/governance_policy.pdf and reproduced in Appendix 16-D to this chapter ("Companies should also require that stock obtained through exercise of options be held for substantial periods of time, apart from sales permitted to meet tax liabilities produced by such exercise."); Hewitt Study Shows Companies Revamping Long-Term Executive Incentive Programs, available at www4.hewitt.com/hewitt/resource/newsroom/pressrel/2004/04-08-04.htm (Apr. 8, 2004) ("Among the related stock option design changes expected in 2004, a small (6 percent) but growing number of companies are considering holding-period requirements after stock options exercise, generally for one additional year."); Business Roundtable, Executive Compensation: Principles and Commentary, Commentary on Principle 4, at 8 (Nov. 2003) ("The compensation committee should consider whether to require that members of senior management hold a specified amount of the stock that they have earned through incentive-based awards for a period of time.").

(n22)Footnote 22. See Statement by Treasury Secretary Tim Geithner on Compensation, available at <http://www.ustreas.gov/press/releases/tg163.htm>.

(n23)Footnote 23. See section 16.01[2], above.

(n24)Footnote 24. See, e.g., the September 15, 2006 letter from Ann Yerger, Executive Director of the Council of Institutional Investors, to 1500 public companies, available at <http://www.cii.org/backdating/index.html>.

(n25)Footnote 25. See Appendix E, Guidance Pertaining to Executive Employment Contracts, to the Report of the Blue Ribbon Commission of the NACD on Executive Compensation and the Role of the Compensation Committee (2003), which is reproduced as Appendix 16-C to this chapter.

(n26)Footnote 26. See also TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, at 20, § B. 5, reproduced in Appendix 16-D to this chapter ("Severance arrangements should not provide contractual payments to executives who are terminated for misconduct, gross mismanagement or other reasons constituting a 'for cause' termination.").

(n27)Footnote 27. Council of Institutional Investors, Council Policies--Director and Management Compensation, available at www.cii.org/dcwascii/web.nsf/doc/policies_iv.cm ("Change-in-control provisions in compensation plans and compensation agreements should be 'double-triggered,' stipulating that compensation is payable only (1) after a control change actually takes place and (2) if a covered executive's job is terminated as a result of the control change."). Note that this restriction goes beyond many best-practices recommendations in that it would disallow severance payments resulting from a change in control followed by a material reduction in salary, benefits or responsibilities, as most change-in-control contracts provide. See also NACD, Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee at Appendix E (2003) reproduced in Appendix 16-C to this chapter (recommending against the use of "single trigger" change-in-control provisions but advocating that the board have discretion to define its own "triggers.").

(n28)Footnote 28. *See* Appendix E, Guidance Pertaining to Executive Employment Contracts, to the Report of the Blue Ribbon Commission of the NACD on Executive Compensation and the Role of the Compensation Committee (2003), which is reproduced as Appendix 16-C to this chapter.

(n29)Footnote 29. *See, e.g.*, TIAA-CREF, Policy Statement on Corporate Governance, Executive Compensation, Equity-Based Compensation, Appendix, reproduced in Appendix 16-D to this chapter. *See* discussion of golden parachute issues in § 16.02[2] above.



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Corporate Governance: Law and Practice

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CHAPTER 16 EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

2-16 Corporate Governance: Law and Practice § 16.06

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§ 16.06 Financial Crisis Legislation

In the wake of the financial crisis, public anger and Congressional attention have become focused on compensation issues. As a result, there have been several pieces of legislation that contain executive compensation restrictions. As discussed in *Section 16.02* of this chapter, in October 2008, Congress enacted the Emergency Economic Stabilization Act ("EESA"), pursuant to which certain financial institutions receive federal assistance under the Troubled Assets Relief Program. Under EESA, recipients of TARP funds are subject to various executive compensation restrictions. Since EESA's enactment, there have been increasingly enhanced compensation restrictions imposed on TARP recipients, including those contained in the American Recovery and Reinvestment Act ("ARRA"), enacted in February 2009. Following ARRA's enactment, there was confusion as to the application of the executive compensation and corporate governance standards applicable to TARP recipients.ⁿ¹ However, on June 10, 2009, the Treasury Department issued an Interim Final Rule (the "Treasury Regulations") to provide guidance on the executive compensation and corporate governance provisions of EESA, as modified by ARRA.ⁿ² The Treasury Regulations consolidate all of the executive compensation-related provisions applicable to TARP recipients and supersede prior rules and guidance.

ARRA prescribes enhanced executive compensation standards for any entity that has received or will receive TARP funds under EESA, applicable during the period in which TARP funds remain outstanding. In addition to the limitation on compensation to exclude incentives for senior executive officers to take unnecessary and excessive risks (which limitation was contained in EESA Section 111(b)(2)(A)), Section 7001 of ARRA does the following:

- Extends the clawback provision of EESA from the top five to the 25 most highly compensated employees. The Treasury Regulations clarify that a TARP recipient must exercise the clawback right unless it can demonstrate that it is unreasonable to do so (e.g., if the cost to enforce the clawback would exceed the amount recovered).
- Extends the prohibition on golden parachute payments in EESA from the top five to the 10 most highly compensated employees, and defines "golden parachute payment" as any payment (as opposed to only payments exceeding three times the officer's average annual taxable income) due to any termination from employment excluding death or disability (as opposed to solely an involuntary termination of

employment). The Treasury Regulations clarify that the following payments are excepted from this prohibition: (1) payments received for services rendered or benefits accrued, including payments under a deferred compensation plan provided that, among other requirements, the plan has been in place for over a year prior to the employee's departure and the employee has a vested right at the time of departure; (2) payments under a qualified pension or retirement plan; and (3) payments required by state or foreign law.

- Prohibits paying or accruing any bonus, retention award or incentive compensation (other than long-term restricted stock in an amount up to 1/3 of the total annual compensation of the recipient and which does not vest while TARP funds remain outstanding) to certain employees (varying between the highest paid employee and the top 25 highest paid employees, depending upon the amount of TARP assistance received by the company). The Treasury Regulations clarify that there is no cap on total annual compensation and provide guidance on what types of payments constitute a bonus, retention award or incentive compensation (e.g., sales commissions are excluded from these definitions, provided that the commission structure is consistent with the TARP recipient's practice prior to the enactment of ARRA).

- Requires annual CEO/CFO certification of compliance with these executive compensation standards.

- Prohibits compensation plans that would encourage manipulation of earnings to enhance the compensation of any employee.

- Requires that the compensation committee be comprised solely of independent directors.

- Requires that the compensation committee meet at least semiannually with senior risk officers of the company to discuss and evaluate employee compensation plans and to conduct risk assessment to determine that these plans do not pose unnecessary risks to the company. The Treasury Regulations make clear that the compensation committee must certify annually that it has completed its requisite reviews and provide a narrative description on its risk evaluation, including how the compensation plans "do not encourage behavior focused on short-term results rather than long-term value creation," and how the committee and senior risk officers have limited risk inherent in compensation plans.

- Requires that the company adopt a company-wide excessive or luxury expenditure policy covering at least the following: entertainment or events; office and facility renovations; aviation and other transportation and other activities or events that are "reasonable" or "ordinary course." The Treasury Regulations further provide that each TARP recipient must adopt the policy within a certain time period and provide a copy of the policy to its primary regulatory authority and to the Treasury Department and also post the policy on its website. Any material modifications to the policy similarly must be disclosed.

- Requires that the company hold an annual non-binding shareholder vote to approve the compensation of executives, as disclosed pursuant to SEC disclosure rules ("Say on Pay").

- Authorizes the review of all prior payments of bonuses, retention awards and other compensation to determine whether the payments were inconsistent with TARP or otherwise contrary to public interest and to negotiate reimbursement of these payments. The Treasury Regulations establish the Office of the Special Master for TARP Executive Compensation (the "Special Master") and require the Special Master to, among other things, review prior bonuses, retention awards and other compensation paid before February 17, 2009 to any employee of a TARP recipient to "determine whether any such payments were inconsistent with the purposes of ... TARP, or otherwise contrary to public interest."

ARRA granted the Treasury Department authority to issue additional compensation and corporate governance

standards. Accordingly, the Treasury Regulations contain the following additional standards:

- TARP recipients must provide enhanced disclosure of any perquisite or other personal benefit exceeding \$25,000 annually that is provided to the top 25 highest paid employees. The disclosure must include a discussion of the amount and nature of the perquisite or other personal benefit and a justification for its provision.
- TARP recipients must provide an annual narrative description of whether the TARP recipient or its board of directors or compensation committee has engaged a compensation consultant and all types of services, including non-compensation related services, the consultant or any of its affiliates has provided to the TARP recipient or its governing bodies for the past three years.
- TARP recipients are prohibited from paying tax gross-ups to the top 25 highest paid employees, including promises to pay future tax gross-ups beyond the period the institution participate in TARP. The Treasury Regulations exclude tax equalization arrangements for employees subject to higher taxes in connection with overseas assignments.

These standards (other than Say on Pay, which became effective on February 17, 2009) became effective upon the publication of the Treasury Regulations in the Federal Register on June 15, 2009. As the Treasury Regulations remained open for public comment until August 14, 2009, some of the provisions may change from those originally enacted.

On July 31, 2009, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269.³ The bill would require public companies to provide for an annual non-binding shareholder vote on executive compensation, as disclosed pursuant to SEC disclosure rules. It also would require companies to hold a separate non-binding vote on "golden parachute" payments for named executive officers in connection with shareholder votes on mergers and other corporate transactions "unless ... [the] agreements or arrangements [pursuant to which such payments are to be made] have been subject to a shareholder vote" under the provision requiring an annual advisory vote on the executive compensation of the named executive officers. The bill also includes requirements that (a) "covered financial institutions" (defined to include banks, bank holding companies, broker-dealers, credit unions and investment advisors, as well as any other financial institution subsequently identified by rule adopted jointly by several named federal agencies) disclose all compensation structures that include incentive-based elements, and (b) federal regulators proscribe inappropriate or imprudently risky compensation practices at such covered financial institutions. In addition, the bill includes a requirement that compensation committee members of public companies meet independence standards similar to those required for audit committee members and that compensation consultants satisfy certain independence criteria established by the SEC, each as discussed in Chapter 10 of this treatise. As of the date that this revision goes to press, the bill is pending in the Senate.

Legal Topics:

For related research and practice materials, see the following legal topics:
Mergers & Acquisitions Law
Sales of Assets

FOOTNOTES:

(n1)Footnote 1. See "Treasury Announces New Restrictions on Compensation," *available at* <http://www.ustreas.gov/press/releases/tg15.htm> (outlining a different set of executive compensation standards than those contained in EESA and ARRA),

(n2)Footnote 2. See Treasury Department Interim Final Rule, *available at* <http://www.treas.gov/press/releases/reports/ec%20ifr%20fr%20web%206.9.09tg164.pdf>.

(n3)Footnote 3. The text of the bill as passed by the House of Representatives is *available at*

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3269eh.txt.pdf.



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Corporate Governance: Law and Practice

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Appendix 16-A: Golden Parachute Tax Regulations, 26 CFR § 1.280G-1

2-16-A Corporate Governance: Law and Practice Appendix 16-A:.syn

§ 16-A.syn Synopsis to Appendix 16-A: Golden Parachute Tax Regulations, 26 CFR § 1.280G-1

[16-A] Golden Parachute Tax Regulations, 26 CFR § 1.280G-1



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Appendix 16-A: Golden Parachute Tax Regulations, 26 CFR § 1.280G-1

2-16-A Corporate Governance: Law and Practice [16-A]

[16-A] Golden Parachute Tax Regulations, 26 CFR § 1.280G-1

**RULES and REGULATIONS
DEPARTMENT OF THE TREASURY**

Internal Revenue Service

§ 1.280G-1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under *section 280G of the Internal Revenue Code of 1986*, as added by section 67 of the Tax Reform Act of 1984 (Pub. L. No. 98-369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Pub. L. No. 99-514; 100 Stat. 2807), section 1018(d)(6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Pub. L. No. 104-188; 110 Stat. 1755). The following is a table of subjects covered in this section:

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Overview

Q-1: What is the effect of *Internal Revenue Code section 280G* ?

A-1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, *see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A)* .

(b)

The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q-2: What is a parachute payment for purposes of section 280G?

A-2: (a) The term parachute payment means any payment (other than an exempt payment described in Q/A-5) that--

- (1) Is in the nature of compensation;
- (2) Is made or is to be made to (or for the benefit of) a disqualified individual;
- (3) Is contingent on a change--

- (i) In the ownership of a corporation;

- (ii)

- In the effective control of a corporation; or

- (iii)

- In the ownership of a substantial portion of the assets of a corporation; and

- (4)

Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A-2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

- (b)

Hereinafter, a change referred to in paragraph (a)(3) of this A-2 is generally referred to as a change in ownership or control. For a discussion of the application of paragraph (a)(1), *see* Q/A-11 through Q/A-14; paragraph (a)(2), Q/A-15 through Q/A-21; paragraph (a)(3), Q/A-22 through Q/A-29; and paragraph (a)(4), Q/A-30 through Q/A-36.

- (c)

The term parachute payment also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a securities violation parachute payment. *See* Q/A-37 for the definition and treatment of securities violation parachute payments.

Q-3: What is an excess parachute payment for purposes of section 280G?

A-3: The term excess parachute payment means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, *see* Q/A-37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, *see* Q/A-38 through Q/A-44.

Q-4: What is the effective date of section 280G and this section?

A-4: In general, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment that is contingent on a change in ownership or control and the change in ownership or control occurs on or after January 1, 2004. For a discussion of the application of the effective date, *see* Q/A-47 and Q/A-48.

Exempt Payments

Q-5: Are some types of payments exempt from the definition of the term parachute payment?

A-5: (a) Yes, the following five types of payments are exempt from the definition of parachute payment--

(1)

Payments with respect to a small business corporation (described in Q/A-6 of this section);

(2)

Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A-6 of this section);

(3)

Payments to or from a qualified plan (described in Q/A-8 of this section);

(4)

Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the *Internal Revenue Code*: *section 501(c)* (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)), section 501(d), or section 529, collectively referred to as tax-exempt organizations (described in Q/A-6 of this section); and

(5)

Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A-9 of this section).

(b)

Deductions for payments exempt from the definition of parachute payment are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section.

Q-6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A-5 of this section are exempt from the definition of parachute payment?

A-6: (a) The term parachute payment does not include--

(1)

Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a corporation under section 1361 in effect on the date of the change in ownership or control;

(2)

Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A-6) if--

(i)

Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii)

The shareholder approval requirements described in Q/A-7 of this section are met with respect to such payment; or

(3)

Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A-5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b)

For purposes of paragraph (a)(1) of this A-6, the members of an affiliated group are not treated as one corporation.

(c)

The requirements of paragraph (a)(2)(i) of this A-6 are not met with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets. If a corporation is a member of an affiliated group (which group is treated as one corporation under A-46 of this section), the requirements of paragraph (a)(2)(i) of this A-6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d)

For purposes of paragraph (a)(2)(i) of this A-6, the term stock does not include stock described in section 1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e)

For purposes of paragraph (a)(2)(i) of this A-6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f)

For purposes of paragraph (a)(2)(i) of this A-6, the term established securities market means an established securities market as defined in § 1.897- 1(m).

(g)

The following examples illustrate the application of this exemption:

Example 1.

A small business corporation (within the meaning of paragraph (a)(1) of this A-6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2.

Assume the same facts as in Example 1, except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A-6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A-7 of this section are met, the payments are not parachute payments.

Example 3.

Stock of Corporation S is owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A-2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of parachute payments under this A-6.

Example 4.

A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A-5(a)(4), would constitute a parachute payment. However, one or more aspects of the transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control, as required by this A-6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of parachute payment under this A-6.

Example 5.

B is a corporation described in section 501(c)(15). B does not meet the definition of a tax-exempt organization because section 501(c)(15) does not expressly prohibit inurement of B's net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a parachute payment, such payment is not exempt from the definition of the term parachute payment for purposes of this A-6.

Q-7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section met?

A-7: (a) General rule. The shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section are met with respect to any payment if--

(1)

Such payment is approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A-7) immediately before the change in ownership or control; and

(2)

Before the vote, there was adequate disclosure to all persons entitled to vote (as described in this A-7) of all material facts concerning all material payments which (but for Q/A-6 of this section) would be parachute payments with respect to a disqualified individual.

(b)

Voting requirements--(1) General rule. The vote described in paragraph (a)(1) of this A-7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. Except as otherwise provided in this A-7, the normal voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A-7. For purposes of this A-7, the vote can be on less than the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A-6 of this section.

(2)

Special rule. A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within the six-month period immediately prior to and ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A-7 are met.

(3)

Entity shareholder. (i) Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. *See* paragraph (b)(4) of this A-7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met.

(ii)

However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder entitled to vote. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this (b)(3)(ii), stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4)

Disqualified individuals and attribution of stock ownership. In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A-7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75 percent vote has been obtained under this A-7 if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. In addition, if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements described in this A-7 are not met, such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder, or in the case of a trust another person eligible to vote on behalf of the trust, to vote the otherwise eligible shares. However, if all persons who hold voting power in the corporation undergoing the change in ownership or control are disqualified individuals or related persons described in this paragraph (b)(4), then such stock is counted as outstanding stock and votes by such persons are considered in determining whether the more than 75 percent vote has been obtained.

(c)

Adequate disclosure. To be adequate disclosure for purposes of paragraph (a)(2) of this A-7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made. Disclosure of such information must be made to every shareholder of the corporation entitled to vote under this A-7. For each disqualified individual, material facts that must be disclosed include, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are not met, and a brief description of each payment (e.g., accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d)

Corporation without shareholders. If a corporation does not have shareholders, the exemption described in Q/A-6(a)(2) of this section and the shareholder approval requirements described in this A-7 do not apply. Solely for purposes of this paragraph (d), a shareholder does not include a member in an association, joint stock company, or insurance company.

(e)

Examples. The following examples illustrate the application of this A-7:

Example 1.

Corporation S has two shareholders--Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to certain officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock entitled to vote of Corporation P and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 2.

(i) Stock of Corporation X, none of which is traded on an established market, is acquired by Corporation Y. In the voting ballot concerning the sale, the Corporation X shareholders are asked to vote either "yes" on the sale and "yes" to paying parachute payments to A, a disqualified individual with respect to Corporation A, or "no" on the sale and "no" to paying parachute payments to A.

(ii)

Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A-7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of parachute payment pursuant to Q/A-6 of this section.

(iii)

Assume the same facts as in paragraph (i) of this Example 2, except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A-7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments cannot be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A-7 are met, the payments are exempt from the definition of parachute payment pursuant to Q/A-6 of this section.

Example 3.

Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. The general partner is not a disqualified individual. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A-7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 4.

Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A-7 are not met. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the shareholder approval requirements of paragraph (a)(1) of this A-7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not entitled to vote.

Example 5.

Assume the same facts as in Example 4, except that after adequate disclosure of all material facts (within the meaning of paragraph (a)(2) of this A-7) to all shareholders entitled to vote, 60 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent of the shareholders holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6.

Assume the same facts as in Example 4 except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A-7) regarding the payments to X and Y is made to two of Corporation A's shareholders, who collectively own 80 percent of Corporation A's stock entitled to vote and approve the payment. Both shareholders approve the payments. Assume further that no adequate disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A-7. Notwithstanding that 80 percent of the shareholders entitled to vote approve the payments, because disclosure regarding the payments to X and Y is not made to all of Corporation A's shareholders who were entitled to vote, the disclosure requirements of paragraph (a)(2) of this A-7 are not met, and the payments are not exempt from the definition of parachute payment pursuant to Q/A-6.

Example 7.

Corporation C has three shareholders--Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P's base amount. To determine the persons who are entitled to vote referred to in paragraph (a)(1) of this A-7, one-third of the stock held by

Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual who would receive a parachute payment if the requirements of this A-7 are not met), to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8.

X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). Each individual has a base amount of \$100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of \$400,000 is payable to X; \$600,000 is payable to Y; and \$1,000,000 is payable to Z. Corporation E provides each Corporation E shareholder entitled to vote (as determined under this A-7) with a ballot listing and describing the payments of \$400,000 to X; \$600,000 to Y; and \$1,000,000 to Z and the triggering event that generated the payments. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a "yes" and "no" box) of each total payment to be made to each individual and states that if the payment is not approved the payment will not be made. Adequate disclosure, within the meaning of this A-7 is made to each shareholder entitled to vote under this A-7. More than 75 percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A-7 approve each payment to each individual. The shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 9.

Assume the same facts as in Example 8 except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that \$2,000,000 in payments will be made to X, Y, and Z and requests approval of the \$2,000,000 payments. Assuming the triggering event and amount of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A-7, the shareholder approval requirements of paragraph (a)(1) of this A-7 are met, and the payments are exempt from the definition of parachute payment pursuant to A-6 of this section.

Example 10.

B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B's base amount is \$205,000. Under B's employment agreement with Corporation X, in the event of a change in ownership or control, B's stock options will vest and B will receive severance and bonus payments. Contingent on the change in ownership or control, B's stock options with a fair market value of \$500,000 immediately vest, \$200,000 of which is contingent on the change, and B will receive a \$200,000 bonus payment and a \$400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote as described in this A-7. The ballot contains adequate disclosure of all material facts and lists the following payments to be made to B: The contingent payment of \$200,000 attributable to options, a \$200,000 bonus payment, and a \$400,000 severance payment. The ballot requests shareholder approval of the \$200,000 bonus payment to B and states that whether or not the \$200,000 bonus payment is approved, B will receive \$200,000 attributable to options and a \$400,000 severance payment. More than 75 percent of the shareholders entitled to vote as described by this A-7 approve the \$200,000 bonus payment to B. The shareholder approval requirements of this A-7 are met, and the \$200,000 payment is exempt from the definition of parachute payment pursuant to A-6 of this section.

Q-8: Which payments under a qualified plan are exempt from the definition of parachute payment?

A-8: The term parachute payment does not include any payment to or from--

(a)

A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b)

An annuity plan described in section 403(a);

(c)

A simplified employee pension (as defined in section 408(k)); or

(d)

A simple retirement account (as defined in section 408(p)).

Q-9: Which payments of reasonable compensation are exempt from the definition of parachute payment?

A-9: Except in the case of securities violation parachute payments, the term parachute payment does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. *See* Q/A- 37 of this section for the definition and treatment of securities violation parachute payments. *See* Q/A-40 through Q/A-44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q-10: Who may be the payor of parachute payments?

A-10: Parachute payments within the meaning of Q/A-2 of this section may be paid, directly or indirectly, by--

(i)

The corporation referred to in paragraph (a)(3) of Q/A-2 of this section;

(ii)

A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets; or

(iii)

Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q-11: What types of payments are in the nature of compensation?

A-11: (a) General rule. For purposes of this section, all payments--in whatever form--are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, or a transfer of property. However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b)

When payment is considered to be made. Except as otherwise provided in A-11 through Q/A-13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable year in which it is includible in the disqualified individual's gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c)

Prepayment rule. Notwithstanding the general rule described in paragraph (b) of this A-11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and regulations thereunder; *see* Q/A-32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. However, a disqualified individual may not apply this paragraph (c) of this A-11 to a payment to be made in cash if the present value of the payment would be considered not reasonably ascertainable under section 3121(v) and § 31.3121(v)(2)-1(e)(4) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the applicability of this paragraph (c) to certain payments in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(d)

Transfers of property. Transfers of property are treated as payments for purposes of this A-11. *See* Q/A-12 of this section for rules on determining when such payments are considered made and the amount of such payments. *See* Q/A-13 of this section for special rules on transfers of stock options.

(e)

The following example illustrates the principles of this A-11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of \$100,000 and is entitled to receive two parachute payments, one of \$200,000 and the other of \$400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the \$200,000 payment is made to D at the time of the change in ownership or control. The \$400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999(c) with respect to the \$400,000 payment. Using discount rate determined under Q/A-32, Corporation X and D determine that the present value of the \$400,000 payment is \$300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are \$40,000 ($(\$200,000/\$500,000) \times \$100,000$) and \$60,000 ($(\$300,000/\$500,000) \times \$100,000$), respectively. Thus, the amount of the first excess parachute payment is \$160,000 ($\$200,000 - \$40,000$) and that of the second excess parachute payment is \$340,000 ($\$400,000 - \$60,000$). The excise tax on the \$400,000 payment is \$68,000 ($\$340,000 \times 20$ percent). Assume the present value (calculated in accordance with paragraph (c) of this A-11) of \$68,000 is \$50,000. To prepay the excise tax due on the \$400,000 payment, Corporation X must satisfy its obligations under section 4999 with respect to the \$50,000, in addition to the \$32,000 withholding required with respect to the \$200,000 payment.

Q-12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A-12: (a) Except as provided in this A-12 and Q/A-13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in § 1.83-3(a)) to the disqualified individual and becomes substantially vested (as defined in § 1.83-3(b) and (j)) in such individual. The amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b)

An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A-12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, for purposes of this section, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c)

See Q/A-13 of this section for rules on applying this A-12 to transfers of stock options.

(d)

The following example illustrates the principles of this A-12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of § 1.83-3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of § 1.83-3(c)) and are nontransferable (within the meaning of § 1.83-3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is \$250 per share. Because A's rights in the Corporation M stock become substantially vested (within the meaning of § 1.83-3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to \$25,000 (100 x \$250). See Q/A-38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q-13: How are transfers of statutory and nonstatutory stock options treated?

A-13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in § 1.83-7(b)). For purposes of this A-13, vested means substantially vested within the meaning of § 1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: The difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value. For purposes of this A-13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(b)

Any money or other property transferred to the disqualified individual on the exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A-13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A-11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A-13 treated as an excess parachute payment.

Q-14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A-14: Yes, to the extent not otherwise taken into account under Q/A-12 and Q/A-13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q-15: Who is a disqualified individual?

A-15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation --

(1)

A shareholder (but *see* Q/A-17 of this section);

(2)

An officer (*see* Q/A-18 of this section); or

(3)

A highly-compensated individual (*see* Q/A-19 of this section).

(b)

For purposes of this A-15, a director is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period, the director is, with respect to the corporation, a shareholder (*see* Q/A-17 of this section), an officer (*see* Q/A-18 of this section), or a highly-compensated individual (*see* Q/A-19 of this section).

(c)

For purposes of this A-15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

Q-16: Is a personal service corporation treated as an individual?

A-16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b)

The following example illustrates the principles of this A-16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of highly-compensated individuals of Corporation M as determined under A-19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q-17: Are all shareholders of a corporation considered shareholders for purposes of paragraphs (a)(1) and (b) of Q/A-15 of this section?

A-17: (a) No. Only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation's stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer (*see* Q/A-18) or highly-compensated individual (*see* Q/A-19) with respect to the corporation.

(b)

For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A-17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§ 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A-17, mutual and cooperative corporations are treated as having stock.

(c)

The following examples illustrates the principles of this A-17:

Example 1.

E, an employee of Corporation A, received options under Corporation A's Stock Option Plan. E's stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period. E does not own, and is not considered to own under section 318, any other Corporation A stock. Two years after the options are granted to E, all of Corporation A's stock is acquired by Corporation B. Under Corporation A's Stock Option Plan, E's options are converted to Corporation B options and the vesting schedule remains the same. Under paragraph (b) of this A-17, the stock underlying the unvested options held by E on the date of the change

in ownership or control is not considered owned by E. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q&A-15 of this section with respect to Corporation A.

Example 2.

Assume the same facts as in Example 1, except that Corporation A's Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. Under paragraph (b) of this A-17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/A-15 of this section with respect to Corporation A.

Example 3.

Assume the same facts as in Example 1 except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A's Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. Under paragraph (b) of this A-17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A-15 of this section with respect to Corporation A.

Q-18: Who is an officer?

A-18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction.

(b)

An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A-46 of this section is treated as an officer of such one corporation.

(c)

No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of

the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A-21 of this section) paid during the disqualified individual determination period.

(d)

In determining the total number of employees of a corporation for purposes of this A-18, employees are not counted if they normally work less than 17 1/2 hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be an officer.

Q-19: Who is a highly-compensated individual?

A-19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A-21 of this section) earned during the disqualified individual determination period (as defined in Q/A-20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b)

An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c)

The total number of employees of a corporation for purposes of this A-19 is determined in accordance with Q/A-18(d) of this section. However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q-20: What is the disqualified individual determination period?

A-20: The disqualified individual determination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q-21: How is compensation defined for purposes of determining who is a disqualified individual?

A-21: (a) For purposes of determining who is a disqualified individual, the term compensation means the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a nonqualified deferred compensation plan.

(b)

For purposes of this A-21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term related entity includes--

(1)

All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2)

All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3)

All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4)

Any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c)

For purposes of Q/A-18 and Q/A-19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q-22: When is a payment contingent on a change in ownership or control?

A-22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (*But see* Q/A-23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A-22, vested means the payment is substantially vested within the meaning of § 1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by section 83(c).

(b)

(1)

For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if--

(i)

The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii)

A change in ownership or control actually occurs; and

(iii)

The event is materially related to the change in ownership or control.

(2)

For purposes of paragraph (b)(1)(i) of this A-22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely

associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; a significant reduction in the disqualified individual's job responsibilities; and a change in ownership or control as defined in the disqualified individual's employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A-27, 28, or 29 of this section. Whether other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3)

For purposes of determining whether an event (as described in paragraph (b)(2) of this A-22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent on a change in ownership or control because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c)

A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated with and materially related to a change in ownership or control within the meaning of paragraph (b)(1) of this A-22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. *See* Q/A-24 of this section regarding the portion of a payment that is so treated. *See also* Q/A-8 of this section regarding the exemption for certain payments under qualified plans and Q/A-40 of this section regarding the treatment of a payment as reasonable compensation.

(d)

A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e)

The following examples illustrate the principles of this A-22:

Example 1.

A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2.

A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A-22. This is true even though B's termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control.

Example 3.

A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C's employment is terminated at any time over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership or control of the corporation occurs. Six months after the change in ownership or control, C's employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership or control, the termination of C's employment is presumed to be materially related to the change in ownership or control under paragraph (b)(3) of this A-22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership or control under paragraph (b) of this A-22.

Example 4.

A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender offer for shares of the corporation's stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership or control of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A-37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5.

A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership or control of the corporation occurs and within one year after the date of the change of ownership or control, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change in ownership or control, the payment will not be treated as contingent on a change in ownership or control.

Q-23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A-23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or are to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (*See* Q/A-9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. To the extent payments under the agreement have the same value as the payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b)

The following examples illustrate the principles of this A-23:

Example 1.

Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2.

Assume the same facts as in Example 1, except that the agreement between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A-22 of this section. However, *see* Q/A-9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3.

Assume the same facts as in Example 1, except that prior to the change in ownership or control, the individual and corporation enter into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the

individual agrees to give up the right to payments under the pre-change agreement that would be parachute payments if made, in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A-23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q-24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A-24: (a)(1) General rule. Yes. If the payment is a transfer of property, the amount of the payment is determined under Q/A-12 or Q/A-13 of this section. For all other payments, the amount of the payment is determined under Q/A-11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A-24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A-24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A-24 applies to a payment that becomes vested as a result of the change in ownership or control if, without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time and if the payment is attributable, at least in part, to services performed before the date the payment becomes vested. Paragraph (b) or (c) does not apply to any payment (or portion thereof) if the payment is treated as contingent on the change in ownership or control pursuant to Q/A-25 of this section. For purposes of this A-24, vested has the same meaning as provided in Q/A-22(a).

(2)

Reduction by reasonable compensation. The amount of a payment under paragraph (a)(1) of this A-24 is reduced by any portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services rendered by the disqualified individual on or after the date of the change of control. *See* Q/A-9 and Q/A-38 through 44 of this section for rules concerning reasonable compensation. The portion of an amount treated as contingent under paragraph (b) or (c) of this A-24 may not be reduced by reasonable compensation.

(b)

Vested payments. This paragraph (b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. In such a case, the portion of the payment, if any, that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment. For rules on determining present value, *see* paragraph (e) of this A-24, Q/A-32, and Q/A-33 of this section.

(c)

(1)

Nonvested payments. This paragraph (c) applies to a payment that becomes vested as a result of the change in ownership or control to the extent that--

(i)

Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii)

The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(2)

The portion of the payment subject to paragraph (c) of this A-24 that is treated as contingent on the change in ownership or control is the amount described in paragraph (b) of this A-24, plus an amount, as determined in paragraph (c)(4) of this A-24, to reflect the lapse of the obligation to continue to perform services. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.

(3)

For purposes of this paragraph (c) of this A-24, the acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment.

(4)

The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2) of this A-24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(d)

Application of this A-24 to certain payments.-- (1) Benefits under a nonqualified deferred compensation plan. In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A-24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A-24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A-24 and the rules in Q/A-11 of this section.

(2)

Employment agreements. The general rule of paragraph (a) of this A-24 (and not the rules in paragraphs (b) or (c)) applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A-24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. *See* Q/A-42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3)

Vesting due to an event other than services. Neither paragraph (b) nor (c) of this A-24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A- 24. However, *see* Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

(e)

Present value. For purposes of this A-24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f)

Examples. The following examples illustrate the principles of this A-24:

(i)

Example 1. Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of \$500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii)

Because E was vested in \$500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of this A-24, is treated as contingent on the change. Thus, the portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (\$500,000) exceeds the present value of the payment absent the acceleration.

(iii)

Assume the same facts as in paragraph (i) of this Example 1, except that E's account balance of \$500,000 is not vested. Instead, assume that E will vest in E's account balance of \$500,000 in 2 years if E continues to perform services for the next 2 years. Assume further that the SERP provides that all unvested SERP benefits vest immediately on a change in ownership or control and are paid to the participants. Because the vesting of the SERP payment, without regard to the change, depends only on the performance of services for a specified period of time and the payment is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the \$500,000 payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the lesser of the amount of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration, plus an amount to reflect the lapse of the obligation to continue to perform services.

(iv)

Assume the same facts as in paragraph (i) of this Example 1, except that in addition to the pay out of the vested account balance of \$500,000 on the change in ownership or control, an additional \$70,000 will be credited to E's account and included in the payment to E. Because the \$500,000 was vested without regard to the change in ownership or control, paragraph (b) of this A-24 applies to the \$500,000 payment. Because the \$70,000 is not vested, without regard to the change, and is not attributable to the performance of services prior to the change, the entire \$70,000 payment is contingent on the change in ownership or control under paragraph (a) of this A-24.

(v)

Assume the same facts as in paragraph (i) of this Example 1, except that the benefit under the SERP is calculated using a percentage of final average compensation multiplied by years of service. If, contingent on the change in ownership or control, E is credited with additional years of service, an adjustment to final average compensation, or

an increase in the applicable percentage, any increase in the benefit payable under the SERP is not attributable to the performance of services prior to the change, and the entire increase in the benefit is contingent on the change in ownership or control under paragraph (a) of this A-24.

Example 2.

As a result of a change in the effective control of a corporation D, a disqualified individual with respect to the corporation, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

(i)

Example 3. On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of \$500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment (\$500,000) is made on that date to F. Under these facts, the payment of \$500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, as determined under paragraph (c) of this A-24 is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (i.e., \$500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (i.e., \$406,838, the present value on January 15, 2009, of a \$500,000 payment on January 15, 2011), plus \$115,000 (1 percent x 23 months x \$500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is \$208,162, the sum of \$93,162 (\$500,000-\$406,838) + \$115,000). This result does not change if F actually remains employed until the end of the 5-year period.

(ii)

Assume the same facts as in paragraph (i) of this Example 3, except that the retention bonus will vest on the change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of \$500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the \$500,000 payment is treated as contingent on the change in ownership or control as determined under paragraph (c) of this A-24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A-27, which is \$0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is \$93,573 (1 percent x 23 months x \$406,838 (the present value of a \$500,000 payment)).

(i)

Example 4. On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of § 1.83-3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is \$500,000.

(ii)

Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 (\$500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be \$500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a \$500,000 payment to be made on January 15, 2011, is \$406,838. Thus, the portion of the payment treated as contingent on the change is \$208,162, the sum of \$93,162 (\$500,000-\$406,838), plus \$115,000 (1 percent x 23 months x \$500,000), the amount reflecting the lapse of the obligation to continue to perform services.

(i)

Example 5. On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with Q/A-13, is \$600,000.

(ii)

The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 (\$600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to

perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be \$600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a \$600,000 payment to be made on January 15, 2009, is \$549,964. Thus, the portion of the payment treated as contingent on the change is \$116,036, the sum of \$50,036 (\$600,000- \$549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is \$66,000 (1 percent x 11 months x \$600,000).

(i)

Example 6. Assume the same facts as in Example 5, except that the options become vested periodically (absent a change in ownership or control), with one- third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 2008, change in ownership or control and the options to purchase the remaining 10,000 shares vest as a result of the change in ownership or control.

(ii)

The payment of the options to purchase 10,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment as determined under paragraph (c) of this A-24 is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change in ownership or control is the amount by which the accelerated payment on January 16, 2008 (\$200,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change in ownership or control, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be \$200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a \$200,000 payment to be made on January 15, 2009, is \$183,328.38. Thus, the portion of the payment treated as contingent on the change is \$38,671.62, the sum of \$16,671.62 (\$200,000-\$183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is \$22,000 (1 percent x 11 months x \$200,000).

Example 7.

Assume the same facts as in Example 5, except that the option agreement provides that the options will vest either on the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 2008. In such case, the full amount of the payment, \$600,000, is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A-24 do not apply. *See* Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8.

On January 1, 2005, E, a disqualified individual with respect to Corporation X, enters into an

employment agreement with Corporation X under which E will be paid wages of \$200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2006, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of \$200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (i.e., amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A-24 applies to the payment and not the rules of paragraphs (b) and (c) of this A-24. *See* Q/A-42(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q-25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A-25: Yes, for purposes of this section, any payment is presumed to be contingent on such a change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to--

(a)

An agreement entered into within one year before the date of a change in ownership or control; or

(b)

An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control. In the case of an amendment described in paragraph (b) of this A-25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q-26: How may the presumption described in Q/A-25 of this section be rebutted?

A-26: (a) To rebut the presumption described in Q/A-25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the content of the agreement or amendment and the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

(b)

In the case of an agreement described in Q/A-25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control--

(1)

A nondiscriminatory employee plan or program as defined in paragraph (c) of this A-26;

(2)

A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3)

A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c)

For purposes of this section, the term nondiscriminatory employee plan or program means: a group term life insurance plan that meets the requirements of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under § 601.601(d)(2). Payments under certain other plans are exempt from the definition of parachute payment under Q/A-8 of this section.

(d)

The following examples illustrate the application of the presumption:

Example 1.

A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change in ownership or control and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which

payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 2.

Assume the same facts as in Example 1, except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership or control would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or control even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 3.

A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership or control of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. If clear and convincing evidence does not rebut the presumption described in A-25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership or control, the payment is presumed contingent on the change under A-25 of this section. This is true even though A's termination of employment is presumed not to be materially related to the change in ownership or control under Q/A-22 of this section.

Change in Ownership or Control

Q-27: When does a change in the ownership of a corporation occur?

A-27: (a) For purposes of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A-27), acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A-28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (See Q/A-29 for rules regarding the transfer of assets of a corporation).

(b)

For purposes of paragraph (a) of this A-27, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c)

For purposes of this A-27 (and Q/A-28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A-27.

(d)

The following examples illustrate the principles of this A-27:

Example 1.

Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and an additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2.

All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3.

Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 40 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group in their

acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger. *See* Q/A-29, Example 3, regarding whether there is a change in ownership or control of P.

Example 4.

Assume the same facts as in Example 3, except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock and the former shareholders of Corporation O own stock with a fair market value equal to 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger. *See* Q/A-29, Example 3, regarding whether there is a change in ownership or control of P.

Example 5.

A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation O. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6.

Assume the same facts as in Example 5, except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q-28: When does a change in the effective control of a corporation occur?

A-28: (a) Notwithstanding that a corporation has not undergone a change in ownership under Q/A-27, for purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either--

(1)

Any one person, or more than one person acting as a group (as determined under paragraph (e) of this A-28), acquires (or has acquired during the 12- month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2)

A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

(b)

The presumption of paragraph (a) of this A-28 may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A-28, a change in the effective control of a corporation is presumed not to have occurred.

(c)

In no event does a change in effective control under this A-28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A-27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O's stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A-29 of this section, O does not have a change in effective control under Q/A-28.

(d)

If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A- 28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A-27 of this section).

(e)

For purposes of this A-28, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f)

For purposes of determining stock ownership, *see* Q/A-27(c).

(g)

The following examples illustrate the principles of this A-28:

Example 1.

Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M's voting stock. Because A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A-28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), a change in the ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A-27 of this section) because A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example 2.

A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q-29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A-29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c) of this A-29), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This A-29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A-29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q/A-46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not surviving entity.

(b)

(1) There is no change in ownership or control under this A-29 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to--

(i)

A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its

stock;

(ii)

An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii)

A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv)

An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(1)(iii) of this A-29.

(2)

For purposes of paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest in before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c)

For purposes of this A-29, persons will not be considered to be acting as a group merely because they happen to purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d)

For purposes of determining stock ownership, *see* Q/A-27(c).

(e)

The following examples illustrate the principles of this A-29:

Example 1.

Corporation M acquires assets having a gross fair market value of \$500,000 from Corporation N (an unrelated corporation) on January 1, 2006. The total gross fair market value of Corporation N's assets immediately prior to the acquisition was \$3 million. Since the value of the assets acquired by Corporation M is less than one-third of the total gross fair market value of Corporation N's total assets immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example 2.

Assume the same facts as in Example 1. Also assume that on November 1, 2006, Corporation M acquires from Corporation N additional assets having a fair market value of \$700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of \$1.2 million during the 12-month period ending on November 1, 2006. Since \$1.2 million is more than one-third of the total gross fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions (\$3 million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 2006.

(i)

Example 3. All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P (based on ownership of Corporation P prior the change), the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P. However, a change in the ownership (within the meaning of Q/A-27) of Corporation O occurs.

(ii)

The result in paragraph (i) would be the same if immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P. *See* Q/A- 27, Example 4, regarding whether there is a change in ownership or control of O.

Example 4.

Corporation P sells all of the stock of its wholly-owned subsidiary, S, to Corporation Y. The fair market value of the affiliated group, determined without regard to its liabilities, is \$210 million. The fair market value of S, determined without regard to its liabilities, is \$80 million. Because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group.

Three-Times-Base-Amount Test for Parachute Payments

Q-30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A-30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual's base amount (as defined in Q/A-34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of the payment is a parachute payment. *See* Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. *See* Q/A-37 of this section for the definition and treatment of securities violation parachute payments.

(b)

The following examples illustrate the principles of this A-30:

Example 1.

A is a disqualified individual with respect to Corporation M. A's base amount is \$100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling \$400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A's base amount of \$100,000 ($3 \times \$100,000 = \$300,000$).

Example 2.

Assume the same facts as in Example 1, except that the payments contingent on the change in the ownership or control of Corporation M total \$290,000. Because the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q-31: As of what date is the present value of a payment determined?

A-31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

(b)

(1)

For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A-32 of this section and based on reasonable actuarial assumptions.

(2)

If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A-31 and for applying the 3-times-base- amount test under Q/A-30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A-30 and this A-31, the obligation to provide health care is permitted to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q-32: What discount rate is to be used to determine present value?

A-32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). *See* Q/A-24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q-33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A-33: (a) In certain cases, it may be necessary to apply the 3-times-base- amount test of Q/A-30 of this section, or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section, at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(b)

If the estimate made under paragraph (a) of this A-33 is later determined to be incorrect, the 3-times-base-amount test described in Q/A-30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base- amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A-31 of this section, using the discount rate described in A-32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times- base-amount test without regard to the payment described in paragraph (a) of this A-33, a disqualified individual is determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A-33 is made

(or becomes certain to be made) if no base amount is allocated to such payment.

(c)

To the extent provided in published guidance of general applicability under § 601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A-13 of this section is permitted to be made, with the valuation subsequently re-determined, and the 3-times-base-amount test reapplied.

(d)

The following examples illustrate the principles of this A-33:

Example 1.

A, a disqualified individual with respect to Corporation M, has a base amount of \$100,000. Under A's employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of \$250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of \$150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M occurs and A receives the first payment of \$250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), because M reasonably estimates that there is a 50-percent or greater probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the \$150,000 payment will be made to A as a result of the change in ownership or control. The present value of the additional payment is determined under Q/A-31 and Q/A-32 of this section.

Example 2.

Assume the same facts as in Example 1, except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test, because Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the \$150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3.

B, a disqualified individual with respect to Corporation P, has a base amount of \$200,000. Under B's employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of \$600,000 and a bonus payment of \$400,000. In addition, the agreement provides that if B's employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of \$500,000. A change in ownership or control of Corporation P occurs, and B receives the \$600,000 and \$400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the change. For purposes of applying the

3-times-base-amount test, because Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the date of the change, Corporation P assumes that the \$500,000 payment will not be made to B. Eleven months after the change in ownership or control, B's employment is terminated, and the \$500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the \$500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the \$500,000 payment. The entire \$500,000 payment is treated as an excess parachute payment.

Q-34: What is the base amount?

A-34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity as defined in Q/A-21 of this section) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. *See* Q/A-35 of this section for the definition of base period and for examples of base amount computations.

(b)

If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c)

Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d)

The base amount includes the amount of compensation included in income under section 83(b) during the base period. *See* Q/A-35 for the definition of base period.

(e)

The following example illustrates the principles of this A-34:

Example. A disqualified individual, D, receives an annual salary of \$500,000 per year during the 5-year base period. D defers \$100,000 of D's salary each year under the corporation's nonqualified deferred compensation plan. D's base amount is \$400,000 ($\$400,000 \times (5/5)$).

Q-35: What is the base period?

A-35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A-27, Q/A-28, or Q/A-29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A-21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b)

The following examples illustrate the principles of Q/A-34 of this section and this Q/A-35:

Example 1.

A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D's includible compensation income from the corporation was \$30,000 for the 4-month period, \$120,000 for the first full year, and \$150,000 for the second full year. D's base amount is \$120,000, $((3 \times \$30,000) + \$120,000 + \$150,000)/3$.

Example 2.

Assume the same facts as in Example 1, except that D also received a \$60,000 signing bonus when D's employment with the corporation commenced at the beginning of the 4-month period. D's base amount is \$140,000, $((\$60,000 + (3 \times \$30,000)) + \$120,000 + \$150,000) / 3$. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D's compensation for the 4-month period.

Example 3.

E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives \$30,000 per year for E's services. In 2006, E becomes an officer of X. E's includible compensation from Corporation X is \$250,000 for 2006 and 2007, and \$300,000 for 2008. In 2008, X undergoes a change in ownership or control. E's base amount is \$140,000 $((2 \times \$250,000) + (2 \times \$30,000)/4)$.

Q-36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A-21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A-36: (a) In such a case, the individual's base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which--

(1)

Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2)

Was not contingent on the change in ownership or control; and

(3)

Was not a securities violation parachute payment.

(b)

The following examples illustrate the principles of this A-36:

Example 1.

On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A-21 of this section). Under the employment contract, A is to receive an annual salary of \$120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 2006, after A has received compensation of \$60,000, a change in the ownership or control of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of \$420,000. It is established by clear and convincing evidence that the \$60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the \$420,000 payment is contingent on the change is not rebutted. Thus, the payment of \$420,000 is treated as contingent on the change in ownership or control of Corporation M. In this case, A's base amount is \$120,000 (2 x \$60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M (\$420,000) is more than 3 times A's base amount of \$120,000 (3 x \$120,000 = \$360,000), the payment is a parachute payment.

Example 2.

Assume the same facts as in Example 1, except that A also receives a signing bonus of \$50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership or control. When the change in ownership or control occurs on July 1, 2006, A has received compensation of \$110,000 (the \$50,000 bonus plus \$60,000 in salary). In this case, A's base amount is \$170,000 (\$50,000 + (2 x \$60,000)). Because the \$50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment (\$420,000) is less than 3 times A's base amount of \$170,000 (3 x \$170,000 = \$510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q-37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A-37: (a) No, the term parachute payment also includes any payment (other than a payment exempted under Q/A-6 or Q/A-8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be

made--

(1)

Pursuant to an agreement that violates any generally enforced Federal or state securities laws or regulations;
and

(2)

In connection with a potential or actual change in ownership or control.

(b)

A violation is not taken into account under paragraph (a)(1) of this A-37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A-37 are referred to in this section as securities violation payments.

(c)

Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A-22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A-38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(d)

The rules in paragraph (b) of this A-37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(e)

The following examples illustrate the principles of this A-37:

Example 1.

A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A-37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2.

Assume the same facts as in Example 1, except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3.

B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of parachute payment pursuant to Q/A-9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed 3 times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4.

Assume the same facts as in Example 3, except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q-38: How is the amount of an excess parachute payment computed?

A-38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. *See* Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value and Q/A-34 of this section for the definition of base amount.

(b)

The following example illustrates the principles of this A-38:

Example. An individual with a base amount of \$100,000 is entitled to receive two parachute payments, one of \$200,000 and the other of \$400,000. The \$200,000 payment is made at the time of the change in ownership or control, and the \$400,000 payment is to be made at a future date. The present value of the \$400,000 payment is \$300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are \$40,000 ($(\$200,000/\$500,000) \times \$100,000$) and \$60,000 ($(\$300,000/\$500,000) \times \$100,000$), respectively. Thus, the amount of the first excess parachute payment is \$160,000 ($\$200,000 - \$40,000$) and that of the second is \$340,000 ($\$400,000 - \$60,000$).

Q-39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A-39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A-24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A-6 through Q/A-9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b)

The following examples illustrate the principles of this A-39:

Example 1.

Assume that a parachute payment of \$600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is \$100,000. Also assume that \$300,000 of the \$600,000 parachute payment is established as reasonable compensation for personal

services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is \$500,000 (\$600,000--\$100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation (\$300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment (\$100,000), and the remainder (\$200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of \$500,000 is reduced by \$200,000 of reasonable compensation.

Example 2.

Assume the same facts as in Example 1, except that the full amount of the \$600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of \$500,000 is reduced to zero by \$500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q-40: How is it determined whether payments are reasonable compensation?

A-40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following--

(1)

The nature of the services rendered or to be rendered;

(2)

The individual's historic compensation for performing such services; and

(3)

The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b)

For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q-41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable

compensation for personal services?

A-41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A-26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. Q/A-46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A-41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of parachute payment under Q/A-8 of this section.

Q-42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A-42: (a) Yes, if payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control--

(1)

The payments were made or are to be made only for the period the individual actually performs such personal services; and

(2)

If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. However, except as provided in paragraph (b) and (c) of this A-42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services contemplated in exchange for the compensation.

(b)

Generally, an agreement under which the disqualified individual must refrain from performing services (e.g., a covenant not to compete) is an agreement for the performance of personal services for purposes of this A-42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A-44 of this section.

(c)

If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control--

(1)

The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;

(2)

The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;

(3)

The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4)

The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer (including involuntary termination or constructive discharge); and

(5)

The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. *See* Q/A-44 of this section for rules regarding damages for a failure to make severance payments.

(d)

The following examples illustrate the principles of this A-42:

Example 1.

A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for \$100,000 for the first year of the contract

and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with A that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A's prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Example 2.

Assume the same facts as in Example 1, except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Example 3.

Assume the same facts as in Example 1, except that under the new contract A agrees to perform consulting services to Corporation N, when and if Corporation N requires A's services. Assume further that when Corporation N does not require A's services, the contract provides that A must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A-42. Assuming the requirements of paragraph (a) of this A-42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Example 4.

Assume the same facts as in Example 1, except that instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A's ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5.

Assume the same facts as in Example 1, except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date

of the change in ownership. Therefore, the amount received by A is exempt from the definition of parachute payment pursuant to Q/A-9 of this section.

Q-43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A-43: Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q-44: May severance payments be treated as reasonable compensation?

A-44: (a) No, severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term severance payment means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual's employment, whenever occurring.

(b)

The following example illustrates the principles of this A-44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of \$200,000 for the first year of the contract, and for each succeeding year, an annual salary that is \$100,000 higher than the previous year. In the event of A's termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X, A's employment is terminated, and A receives \$700,000 (\$300,000 for the second year of the contract plus \$400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the \$700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after the date of the change in ownership or control. Thus, the full amount of the \$700,000 is a parachute payment.

Miscellaneous Rules

Q-45: How is the term corporation defined?

A-45: For purposes of this section, the term corporation has the meaning prescribed by section 7701(a)(3) and § 301.7701-2(b) of this Chapter. For example, a corporation, for purposes of this section, includes a publicly traded partnership treated as a corporation under section 7704(a); an entity described in § 301.7701-3(c)(1)(v)(A) of this Chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q-46: How is an affiliated group treated?

A-46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one

corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A-6, Q/A-7 of this section (except as provided therein)), payor of parachute payments (Q/A-10 of this section), disqualified individuals (Q/A-15 through Q/A-21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A-26 of this section (except as provided therein)), change in ownership or control (Q/A-27, 28, and 29 of this section), and reasonable compensation (Q/A-42, 43, and 44 of this section).

Effective Date

Q-47: What is the general effective date of section 280G?

A-47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract entered into on the day the renewal takes effect.

(b)

For purposes of paragraph (a) of this A-47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c)

Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a supplement to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)

(1)

Except as otherwise provided in paragraph (e) of this A-47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented--

(i)

To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(ii)

To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(iii)

To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2)

For purposes of paragraph (a) of this A-47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e)

A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following--

(1)

The length of time between the adjustment and the change in ownership or control;

(2)

The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3)

A comparison of the adjustment with historical practices of the corporation;

(4)

The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre- June 15, 1984, parachute contracts; and

(5)

The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q-48: What is the effective date of this section?

A-48: This section applies to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

Par 3. In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:



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Appendix 16-B: Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Executive Summary

2-16-A Corporate Governance: Law and Practice Appendix 16-B:.syn

§ 16-A.syn Synopsis to Appendix 16-A: Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Executive Summary

[16-B] Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Executive Summary



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Appendix 16-B: Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Executive Summary

2-16-A Corporate Governance: Law and Practice [16-B]

[16-B] Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Executive Summary *

In the past decade, the level of CEO and executive compensation has risen rapidly. Large pay packages continue to draw considerable criticism from shareholders, the media, regulators, and the general public--especially when these packages are awarded to failed and/or fired executives. For this reason, NACD has convened a Blue Ribbon Commission --following one convened a decade ago-- to make recommendations to boards and compensation committees regarding the appropriate way to compensate executives. The topic is not only timely; it is perennial. Perhaps the most important responsibility of a corporate board of directors is to ensure that the company's management is of the appropriate competence, depth, and integrity to develop and execute a winning long-term strategy for the enterprise. Management leadership, ability, and effort are critical factors in the long-run success of a business, and compensation is a critical component in attracting, motivating, and retaining strong management. This Commission recommends that boards consider several underlying concepts in this regard:

- Reward systems for managerial positions should help attract, motivate, and retain the talent necessary for the long-term success of the corporation.
- Aligning the interests of management (and all employees) with those of investors is at the core of the long-term performance of the corporation.
- Incentive compensation, properly structured, can make a significant difference in how people behave and can help maximize efforts to achieve targeted objectives.
- Compensation plans should balance value to employees throughout the organization with costs to shareholders.

PHILOSOPHY

To start, the compensation committee and the board should work jointly to adopt a compensation philosophy and a set of principles to guide their actions. Clear articulation of an underlying philosophy greatly enhances directors' ability to make rational decisions on behalf of all of the corporation's constituents. This Commission recommends a compensation philosophy and related practices that reflect the principles of independence, fairness, long-term shareholder value, link

to performance, and transparency.

Independence

Independence must be the bedrock value for both the board and its compensation committee. The board needs to ensure that all the members of the compensation committee are independent, knowledgeable, and diligent in the discharge of their duties. Each member of the compensation committee should have the capacity for objective judgment, and the courage and integrity to ask probing questions, to speak honestly, to set and adhere to appropriate limits, and to be an advocate for change when current practice results in negative outcomes. Compensation committees and boards of directors should consider engaging an independent compensation consultant, as needed, to assist in the development of both a compensation philosophy and specific pay packages. The consultant should be hired by and report directly to the committee (or the board, if there is no committee), and should not be retained by the company in any other capacity. However, he or she should have full access to management, their compensation consultants, in-house counsel, and human resources staff.

Fairness

Compensation committees and boards should strive for pay packages that will be perceived as fair, both internally and externally. Internally, fairness means that all members of an organization benefit when the company does well and share in sacrifices when necessary. Fairness also means that there will not be wide gaps between the CEO's pay and the pay of other senior managers--or between executives and other employees--unless these are justified and explained. Externally, pay should relate to performance measured against true peer companies selected by the compensation committee.

Long-Term Shareholder Value

Compensation committees and boards need to design pay packages that encourage longterm commitment to the organization's wellbeing. While executives do need to meet shortterm targets and should be rewarded for doing so, companies should award additional variable compensation based on achieving key metrics over an extended period of time, using company performance measures, rather than stock price, as criteria. Tying bonuses, stock grants, or other compensation to such measures can help align management's personal financial interests with those of shareholders and employees.

Link to Performance

Pay must motivate and reward performance. Compensation committees and boards should never approve generous rewards for executives who have failed to perform or are being terminated. To be effective, pay plans should give managers a long-term stake in the company through ownership requirements and stringent holding periods for that ownership. Compensation packages should include incentives to own stock and disincentives to sell it. Through well-designed compensation, among other things, boards can play a role in building a new cadre of leaders so that corporate leadership is self-sustaining. Whether or not the compensation committee is involved in succession planning, the company's compensation philosophy and framework should support the identification and development of internal candidates for executive positions.

Compensation committee members need to understand the intricacies of compensation-- the various elements that can be used, their appropriate use and purpose, and both the immediate and long-term costs of each. Furthermore, they need to understand how compensation relates to the financial circumstances and business objectives of the corporation. Compensation committees and boards need to set clear performance objectives for senior executives and measure performance against those objectives. Performance objectives should be based on multiple factors--quantitative and qualitative--as opposed to stock price. This activity should not be delegated to the compensation committee, but should occur with full engagement and approval of the board. Pay should be linked to performance as reported. That is,

companies need to honor agreed-upon performance metrics and not change those metrics after the fact in order to provide additional compensation despite failure to achieve stated objectives.

Transparency

Overall, compensation committees and boards need to design plans that are as simple as possible and spell them out in a brief summary that describes company goals, executive performance objectives, and potential payouts under various scenarios. One page should be sufficient in most cases. Simplicity of design and communication will ensure that executives, compensation committees, boards, and investors all understand the compensation package. Full disclosure is vital. Boards should ensure that every element of compensation is fully and clearly disclosed, even if such disclosure is not required. Having such a policy will help to ensure that compensation packages conform to the principles set forth here.

A CRITICAL DIFFERENCE

By following these suggested practices, and by using the practical tools provided throughout this report, compensation committees and boards can make a critical difference in the future of individual companies and in the future of corporate governance in general. Courage is the key, and the time to exercise it is now.

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Appendix 16-C: Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Appendix E: Guidance Pertaining to Executive Employment Contracts

2-16-C Corporate Governance: Law and Practice Appendix 16-C:.syn

§ 16-C.syn Synopsis to Appendix 16-C: Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Appendix E: Guidance Pertaining to Executive Employment Contracts

[16-C] Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Appendix E: Guidance Pertaining to Executive Employment Contracts



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Appendix 16-C: Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Appendix E: Guidance Pertaining to Executive Employment Contracts

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[16-C] Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee -- Appendix E: Guidance Pertaining to Executive Employment Contracts *

Senior executives often sign employment contracts when accepting a position with a company. These contracts can be beneficial, and in some cases may be necessary and prudent. They can, however, lead to problems. A number of the seemingly excessive executive compensation payments in recent years resulted from the fulfillment of contracts. Had no contracts existed, the payments would have been more reasonable.

In light of the problems surrounding executive contracts, some boards have stopped using them for their senior executives, and some corporate CEOs have eschewed them.^{n**}

For boards that use executive employment contracts at senior levels, here are some recommended practices.

- In hiring a new CEO from outside, employ special counsel to prepare any employment agreement on behalf of the committee.
- If existing employment agreements are "evergreen," with automatic extensions on certain dates unless notice is given, do not allow such renewal dates go by without periodic review and affirmative action to extend them.
- Do not treat non-renewal of a contract as an automatic trigger for severance pay.
- Do not extend severance benefits beyond the executive's age 65 or the company's normal retirement date.
- Do not "add years" on to an executive's years of employment in order to increase the executive's retirement package.
- Do not continue to pay active-employment benefits to executives who elect retirement during a severance period in order to start drawing a pension. A decision to retire should trigger retirement benefits, and active benefits should cease.
- Before agreeing to an employment agreement, review company costs under a "worst case" severance benefit.

- Expand the definition of "for cause" termination to include violations of the company's code of business conduct and ethics, as well as violations of its insider-trading policies.
- Condition severance payments on the executive's agreement to standard "no compete, no raid, no sue, no tell" provisions.
- Do not extend special retirement benefits to CEOs of short tenure and undistinguished performance; make any extension of special benefits to a long-serving and honored CEO relatively short in duration.

In any change-of-control provision:

- Do not automatically accelerate vesting of stock options or equity grants. This should occur only at the change of control in cases of cash buyouts, where there is no equity conversion for shareholders, or at an involuntary termination of employment (not for cause) following a change of control.
- Also, refrain from issuing "single trigger" severance benefits for executives following a change of control. A "single trigger" benefit is one that will automatically be awarded if a certain defined event or "trigger" occurs. The board should have the flexibility to select its own triggers for awarding such benefits.
- Finally, periodically review total company costs for severance benefits in case of a change of control, and compare such costs to the company's total equity market capitalization.

FOOTNOTES:

(n2)Footnote **. For example, the co-chairman of this Commission served as CEO of Medtronic, Inc., without a contract.

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Appendix 16-D: TIAA-CREF Policy Statement on Corporate Governance--Executive Compensation (and Appendix thereto on Guidelines for Assessing Compensation Plans)

2-16-D Corporate Governance: Law and Practice Appendix 16-D:.syn

§ 16-D.syn Synopsis to Appendix 16-D: TIAA-CREF Policy Statement on Corporate Governance--Executive Compensation (and Appendix thereto on Guidelines for Assessing Compensation Plans)

[16-D] TIAA-CREF Policy Statement on Corporate Governance--Executive Compensation (and Appendix thereto on Guidelines for Assessing Compensation Plans)



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Appendix 16-D: TIAA-CREF Policy Statement on Corporate Governance--Executive Compensation (and Appendix thereto on Guidelines for Assessing Compensation Plans)

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[16-D] TIAA-CREF Policy Statement on Corporate Governance--Executive Compensation (and Appendix thereto on Guidelines for Assessing Compensation Plans) *

As described earlier, the board is responsible for ensuring that a compensation program is in place which will attract, retain and motivate strong management and which complies with the board's equity policy. TIAA-CREF believes that aligning the rewards of employees with those of shareholders will enhance the long-term performance of the corporation, and compensation programs that are based on performance can play the critical role in this alignment. Thus, TIAA-CREF encourages the board to work with consultants who are independent of management to develop carefully designed cash pay, stock-based compensation and fringe benefit programs that are clearly understood by management and shareholders, and based on the following principles:

1. Compensation plans should be reasonable and fair by prevailing industry standards and able to withstand the critical scrutiny of investors, employees and the public at large.
2. Compensation plans should be understandable and appropriate to the corporation's size, complexity and performance.
3. Disclosure to shareholders about executive compensation should be full and complete and should be adequate to enable a reasonably sophisticated investor to evaluate and assess the total compensation package as well as particular elements.
4. In setting compensation levels and incentive opportunities, the board should consider the individual's experience, expertise, responsibilities and goals and objectives, in addition to overall corporate performance. The board should also consider comparative industry pay levels. However, surveys should be considered cautiously. Surveys that appear to call for stock option use inconsistent with the board's equity policy or clearly in excess of levels that can be explained to shareholders should be disregarded.
5. Compensation plans should encourage employees to achieve performance objectives and in so doing, create long-term shareholder value subject to appropriate consideration of the firm's reputation, integrity and ethical standards.
6. Compensation plans should be objectively linked to appropriate parameters of company performance, such as earnings, return on capital or other relevant financial or operational measures that are within the control of the

executives who will receive the pay. Compensation plans should be based on a performance measurement cycle that is consistent with the business cycle of the corporation.

A. Equity-based Compensation

Shareholder interests are greatly affected by equity-based compensation plans. Equity-based compensation can be a critical element of compensation and can provide the greatest opportunity for the creation of wealth for managers whose efforts contribute to the creation of value for shareholders. Thus, equity-based compensation plans can offer the greatest incentives. At the same time, they can offer significant incentives for abuse. There is a need for regulatory organizations to require realistic accounting of the cost of equity-based plans to the company so as to eliminate the excesses that have diminished the usefulness of these plans to shareholders. As a matter of public policy, TIAA-CREF strongly advocates comprehensive disclosure and realistic accounting of equity-based plans, with the cost charged to the income statement. Further, we urge companies to consider the following principles when developing equity-based compensation plans:

1. The use of equity in compensation programs should be limited by the equity policy developed by the board of directors.
2. Equity-based plans should fully disclose the size of grants, potential value to recipients, cost to the company, and plan provisions that could have a material impact on the number and value of shares distributed. Disclosure should also include information about the extent to which individual managers have hedged or otherwise reduced their exposure to changes in the company's stock price.
3. All plans that provide for the distribution of stock or stock options to employees and/or directors should be submitted to shareholders for approval.
4. Equity-based plans should emphasize restricted stock awards. Restricted stock more closely aligns the interests of executives with shareholders (as opposed to option grants), and the value to the recipient and cost to the corporation can be determined easily and tracked continuously.
5. Equity-based plans should make judicious use of stock option grants. When used in excess, option grants can provide management with incentives to promote the company's stock price without necessarily improving its performance or long-term value.

When stock options are awarded, a company should develop plans for performance-based options, which set performance hurdles to achieve vesting; premium options, with vesting dependent on attainment of a pre-determined appreciation of stock; and/or indexed options, with a strike price tied to an index. Accounting rules should provide a "level playing field" for consideration of these alternatives; fixed-price options should not receive more favorable accounting treatment. Companies should also require that stock obtained through exercise of options be held for substantial periods of time, apart from sales permitted to meet tax liabilities produced by such exercise.

6. Equity-based plans should specifically prohibit or severely restrict "mega grants," which are grants of stock options of a value, at the time of grant, greater than a reasonable and explainable multiple of the recipient's total cash compensation.
7. Equity-based plans should prohibit the issuance of stock or stock options that are timed to take advantage of non-public information with significant short-term implications for the stock price.

B. Fringe Benefits and Severance Agreements

Fringe benefits are an important component of the compensation plan and can have a significant impact on

shareholders. They can be extremely complex, with high potential for unintended and unearned value transfer to management, and with unanticipated cost to the company. When developing fringe benefit plans, the board should be guided by the same principles of disclosure, reasonableness and fairness that guide development of other compensation plan components.

More specifically, pension plans and executive contracts provide opportunities for earnings transfer and corporate liabilities that must be carefully controlled. Executive pension plans should provide for retirement income formulas that are comparable (as a percentage of final average pay) to that of employees throughout the organization. Supplemental executive retirement plans (SERPs) may be used to supplement "qualified" pension entitlement to allow this total to be achieved; however, SERPs should not be used to enhance retirement benefits beyond that which is reasonable. The following principles should guide the development of SERPs:

1. The eligibility requirements and terms of all SERPs should be fully disclosed.
2. The value of the supplemental payment to which each eligible proxy-level executive is entitled should be estimated and disclosed.
3. "Constructive credit" should be used to replicate full service credit not exceed it.
4. Lump-sum distributions of the SERPs should be allowed; the discount rate used to calculate the lump-sum value of the pension entitlement should approximate the reinvestment rate available at retirement and should be disclosed.
5. The total cost of all supplemental plan obligations should be estimated and disclosed.

Executive contracts and their costs also should be disclosed. Although they can be of substantial value to the corporation and its shareholders, they generally include severance arrangements that may produce substantial continuing obligations that go beyond reasonable parameters. Companies should not provide excessive perquisites during employment or in the post-retirement period. Severance arrangements should not provide contractual payments to executives who are terminated for misconduct, gross mismanagement or other reasons constituting a "for cause" termination. As in other areas, reasonableness, competitive practice, and full disclosure are requirements, and such contracts should protect the interests of the company as well as the executive.

Appendix

Guidelines for Assessing Compensation Plans

Equity-Based Award Compensation

When voting on equity-based compensation plans, TIAA-CREF will consider the following elements of the plan:

Potential Dilution from Stock-Based Plans

Red Flag: Total potential dilution from existing and proposed compensation plans exceeds 15% over duration of plan(s) or 2% in any one year.

Override: Increase threshold to 25% for plans proposed by companies in human-capital-intensive industries in which coverage extends through at least middle management levels. Increase threshold to 20% for firms at the lower range of market equity capitalization.

Comment:

The override conditions are each designed to address a specific consideration. The first addresses the needs of human-capital-intensive industries where generous stock-based grants may be necessary to attract and retain personnel and where significant contributions are made by individuals outside the ranks of senior management. The second override addresses the need to provide compensation with sufficient value at lower capitalization firms, since a given level of dilution has a lower economic value in a firm with lower market capitalization.

Excessive Run Rate from Actual Grants

Red Flag: In the most recent three years, potential dilution from stock and stock option grants averaged in excess of 2% per year.

Override: Increase threshold to 3% for plans proposed by companies in human-capital-intensive industries.

Comment: The "potential dilution" test described above is a snapshot at a given point in time. That test can miss excessive transfer of stock ownership over time, through stock plans, to executives and employees at companies that repeatedly return to the well for more options. This red flag for excessive run rates is based on actual grants at companies requesting shareholder approval for additional share authorizations for employee stock plans.

Reload Options

Red Flag: Proposal provides for granting reload options.

Override: None.

Comment:

Reload options are automatically reloaded after exercise at the then-current market price. They enable the individual receiving them to reap the maximum potential benefit from option awards by allowing him or her to lock in increases in stock price that occur over the duration of the option with no attendant risk.

This creates an additional divergence of interests between the shareholders and the option recipient, and an open-ended force for the dilution of shareholders' equity.

Evergreen Option Plans

Red Flag: Plan contains an evergreen feature that has no termination date and reserves a specified percentage of the outstanding shares for award each year.

Override: None.

Option Mega Grants

Red Flag: Option grants that are excessive in relation to other forms of compensation, are out of proportion to compensation of other employees of the corporation, and/or represent excessive earnings transfer opportunities compared to the scale and/or success of the corporation.

Option Pricing

Red Flag: Unspecified exercise price or exercise price below 100% of fair market value on the date of the grant.

Override: None.

Restricted Stock

Red Flag: A plan limited to restricted stock exceeds 3% dilution, or, for an omnibus plan that potentially would allow award of restricted stock exceeding this level, the company has made grants of restricted stock exceeding 1% of outstanding shares over the last three years.

Override: Arguments for higher dilution from restricted stock may be considered on a case-by-case basis for small-cap companies, or as part of a program to reduce dilution related to prior use of stock options.

Coverage

Red Flag: Plan is limited to a small number of senior employees.

Override: Permits awards to a small number of employees at firms at the lower range of market equity capitalization.

Repricing Options

Red Flag: An option plan gives the company the ability to lower the exercise price of options already awarded where the market price of the stock has declined below the original exercise price ("underwater options").

Override: The company has not repriced options in the past or has excluded senior executives and board members from any repricing and has tied any repricing to a significant reduction in the total number of outstanding options.

Comment: Repricing options after a decline in the stock price undermines the rationale for establishing an option plan in the first place. Repricing gives management a benefit unavailable to shareholders and thereby reduces the alignment of interests between shareholders and management.

Excess Discretion

Red Flag: Significant terms of awards -- such as coverage, option price, or type of award provided for the proposed plan -- are not specified in the proposal.

Override: None.

Bundling

Red Flag: Vote on executive compensation plan is coupled with vote on one or more unrelated proposals.

Override: None.

Fringe Benefits

- Support proposals that require shareholder approval of "golden parachute" severance agreements that exceed IRS guidelines.
- Consider on a case-by-case basis proposals for prior shareholder ratification of all "golden parachute" severance agreements. Voting decisions will depend on the corporate governance profile and prior actions of the company.
- Support proposals to limit additions to supplemental executive retirement plans at the time of executives' retirement.

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Appendix A Business Roundtable, Principles of Corporate Governance 2005

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Introduction



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Appendix A Business Roundtable, Principles of Corporate Governance 2005

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Introduction

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and \$4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

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Principles of Corporate Governance
2005

A White Paper by Business Roundtable, November 2005 Business Roundtable

Foreword and Introduction

Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in corporate governance. Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and \$4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and the well-trained and productive U.S. workforce essential for future competitiveness.

Since May 2002, when Business Roundtable issued its *Principles of Corporate Governance*, U.S. public corporations have witnessed fundamental and accelerated changes in the area of corporate governance, beginning with the passage of the Sarbanes-Oxley Act of 2002 and continuing with the adoption of strengthened listing standards by the securities markets. We note that many of the best practices recommended in the principles are now embedded in the Sarbanes-Oxley Act and in securities market listing standards.

Following the publication of *Principles of Corporate Governance* (May 2002), Business Roundtable issued *Executive Compensation: Principles and Commentary* (November 2003), *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004), and *Guidelines for Shareholder-Director Communications* (May 2005). Other publications from Business Roundtable that have addressed corporate governance include *Statement on Corporate Governance* (September 1997), *Executive Compensation/Share Ownership* (March 1992), *Corporate*

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Governance and American Competitiveness (March 1990), *Statement on Corporate Responsibility* (October 1981), and *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation* (January 1978).

Business Roundtable continues to believe, as we noted in *Principles of Corporate Governance* (2002), that the United States has the best corporate governance, financial reporting and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

Given the fundamental nature of the changes that have occurred during the past several years in the framework of laws and regulations related to corporate governance, as well as in best practices, Business Roundtable believes it is appropriate, once again, to restate our guiding principles of corporate governance. Although applicable legal requirements and securities market listing standards establish minimum requirements, these principles, we believe, should help guide the ongoing advancement of corporate governance practices and, thus, advance the ability of public corporations to compete, create jobs and generate economic growth.

Business Roundtable supports the following guiding principles:

First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner to produce value for shareholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. The CEO and board of directors should set a "tone at the top" that establishes a culture of legal compliance and integrity. Management and directors should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the audit committee and the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation and to make the timely disclosures investors need to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board, through its audit committee, to engage an independent accounting firm to audit the financial statements prepared by management, issue an opinion that those statements are fairly stated in accordance with Generally Accepted Accounting Principles and oversee the corporation's relationship with the outside auditor.

Fifth, it is the responsibility of the board, through its corporate governance committee, to play a leadership role in shaping the corporate governance of the corporation. The corporate governance committee also should select and recommend to the board qualified director candidates for election by the corporation's shareholders.

Sixth, it is the responsibility of the board, through its compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance-based compensation, and determine the compensation of the CEO and senior management.

Seventh, it is the responsibility of the board to respond appropriately to shareholders' concerns.

Eighth, it is the responsibility of the corporation to deal with its employees, customers, suppliers and other constituencies in a fair and equitable manner.

These responsibilities and others are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by

corporate directors and management.

Business Roundtable continues to believe that corporate governance should be enhanced through conscientious and forward-looking action by a business community that focuses on generating long-term shareholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, as well as to serve as guideposts for the public dialogue on evolving governance standards.

I. Key Corporate Actors

Effective corporate governance requires a clear understanding of the respective roles of the board and senior management and of their relationships with others in the corporate structure. The relationships of the board and management with shareholders should be characterized by candor; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.

The board of directors has the important role of overseeing management performance on behalf of shareholders. Its primary duties are to select and oversee a well-qualified and ethical chief executive officer who, with senior management, runs the corporation on a daily basis and to monitor management's performance and adherence to corporate and ethical standards. Effective corporate directors are diligent monitors, but not managers, of business operations.

Senior management, led by the CEO, is responsible for running the day-to-day operations of the corporation and properly informing the board of the status of these operations. Management's responsibilities include strategic planning, risk management and financial reporting.

Shareholders are not involved in the day-to-day management of corporate operations but have the right to elect representatives (directors) to look out for their interests and to receive the information they need to make investment and voting decisions. The board should be responsive to communications from shareholders and should address issues of concern to shareholders.

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, all of whom must be committed to business success through the maintenance of the highest standards of responsibility and ethics. Although there are a number of legal and regulatory requirements that must be met, good governance is far more than a "check-the box" list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal setting, effective decision making, and appropriate monitoring of compliance and performance. Through this vibrant and responsive structure, the CEO, the senior management team and the board of directors can interact effectively and respond quickly and appropriately to changing circumstances, within a framework of solid corporate values, to provide enduring value to the shareholders who invest in the enterprise.

II. The Roles of the Board of Directors and Management

An effective system of corporate governance provides the framework within which the board and management address their respective responsibilities.

The Board of Directors

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- The business of a corporation is managed under the direction of the corporation's board. The board delegates to the CEO -- and through the CEO to other senior management -- the authority and responsibility for managing the everyday affairs of the corporation. Directors monitor management on behalf of the corporation's shareholders.
- Making decisions regarding the selection, compensation and evaluation of a well-qualified and ethical CEO is the single most important function of the board. The board also appoints or approves other members of the senior management team.
- Directors bring to the corporation a range of experience, knowledge and judgment. Directors should not represent the interests of particular constituencies.
- Effective directors maintain an attitude of constructive skepticism; they ask incisive, probing questions and require accurate, honest answers; they act with integrity and diligence; and they demonstrate a commitment to the corporation, its business plans and long-term shareholder value.
- In performing its oversight function, the board is entitled to rely on the advice, reports and opinions of management, counsel, auditors and expert advisers. The board should assess the qualifications of those it relies on and hold managers and advisers accountable. The board should ask questions and obtain answers about the processes used by managers and the corporation's advisers to reach their decisions and recommendations, as well as about the substance of the advice and reports received by the board. When appropriate, the board and its committees should seek independent advice.
- Given the board's oversight role, shareholders and other constituencies can reasonably expect that directors will exercise vigorous and diligent oversight of a corporation's affairs. However, they should not expect the board to micromanage the corporation's business by performing or duplicating the tasks of the CEO and senior management team.
- The board's oversight function carries with it a number of specific responsibilities in addition to that of selecting and overseeing the CEO. These responsibilities include:
 - Planning for management development and succession.* The board should oversee the corporation's plans for developing senior management personnel and plan for CEO and senior management succession. When appropriate, the board should replace the CEO or other members of senior management.
 - Understanding, reviewing and monitoring the implementation of the corporation's strategic plans.* The board has responsibility for overseeing and understanding the corporation's strategic plans from their inception through their development and execution by management. Once the board reviews a strategic plan, it should regularly monitor implementation of the plan to determine whether it is being implemented effectively and whether changes are needed. The board also should ensure that the corporation's incentive compensation program is aligned with the corporation's strategic plan.
 - Understanding and approving annual operating plans and budgets.* The board is responsible for understanding, approving and overseeing the corporation's annual operating plans and for reviewing the annual budgets presented by management. The

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board should monitor implementation of the annual plans to assess whether they are being implemented effectively and within the limits of approved budgets.

Focusing on the integrity and clarity of the corporation's financial statements and financial reporting. The board, assisted by its audit committee, should be satisfied that the financial statements and other disclosures prepared by management accurately present the corporation's financial condition and results of operations to shareholders and that they do so in an understandable manner. To achieve accuracy and clarity, the board, through its audit committee, should have an understanding of the corporation's financial statements, including why the accounting principles critical to the corporation's business were chosen, what key judgments and estimates were made by management, and how the choice of principles and the making of these judgments and estimates affect the reported financial results of the corporation.

Advising management on significant issues facing the corporation. Directors can offer management a wealth of experience and a wide range of perspectives. They provide advice and counsel to management in formal board and committee meetings, and they are available for informal consultation with the CEO and senior management.

Reviewing and approving significant corporate actions. As required by state corporate law, the board reviews and approves specific corporate actions, such as the election of executive officers, the declaration of dividends and (as appropriate) the implementation of major transactions. The board and senior management should have a clear understanding of what level or types of decisions require specific board approval.

Reviewing management's plans for business resiliency. As part of its oversight function, the board should designate senior management who will be responsible for business resiliency. The board should periodically review management's plans to address this issue. Business resiliency can include such items as business risk assessment and management, business continuity, physical and cyber security, and emergency communications.

Nominating directors and committee members and overseeing effective corporate governance. It is the responsibility of the board, through its corporate governance committee, to nominate directors and committee members and oversee the composition, independence, structure, practices and evaluation of the board and its committees.

Overseeing legal and ethical compliance. The board should set a "tone at the top" that establishes the corporation's commitment to integrity and legal compliance. The board should oversee the corporation's compliance program relating to legal and ethical conduct. In this regard, the board should be knowledgeable about the corporation's compliance program and should be satisfied that the program is effective in preventing and deterring violations. The board should pay particular attention to conflicts of interest, including related party transactions.

The CEO and Management

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■ It is the responsibility of the CEO and senior management, under the CEO's direction, to operate the corporation in an effective and ethical manner. As part of its operational responsibility, senior management is charged with:

Operating the corporation. The CEO and senior management run the corporation's day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation's strategic objectives within the annual operating plans and budgets, which are reviewed and approved by the board. In making decisions about the corporation's business operations, the CEO considers the long-term interests of the corporation and its shareholders and necessarily relies on the input and advice of others, including senior management and outside advisers. The CEO keeps the board apprised of significant developments regarding the corporation's business operations.

Strategic planning. The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is completed; and recommend and carry out changes to the plans as necessary.

Annual operating plans and budgets. With the corporation's overall strategic plans in mind, senior management develops annual operating plans and budgets for the corporation and presents the plans and budgets to the board. Once the board has reviewed and approved the plans and budgets, the management team implements the annual operating plans and budgets.

Selecting qualified management, and establishing an effective organizational structure. Senior management is responsible for selecting qualified management and implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.

Identifying and managing risks. Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.

Accurate and transparent financial reporting and disclosures. Senior management is responsible for the integrity of the corporation's financial reporting system and the accurate and timely preparation of the corporation's financial statements and related disclosures in accordance with Generally Accepted Accounting Principles and in compliance with applicable laws and regulations. It is senior management's responsibility -- under the direction of the CEO and the corporation's principal financial officer -- to establish, maintain and periodically evaluate the corporation's internal controls over financial reporting and the corporation's disclosure controls and procedures. In accordance with applicable law and regulations, the CEO and the corporation's principal financial officer also are responsible for certifying the accuracy and completeness of the corporation's financial statements and the effectiveness of the corporation's internal and

disclosure controls.

■ The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its shareholders. Business Roundtable believes that when carrying out this function, corporations should have:

A CEO of integrity. The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

A strong, ethical "tone at the top." The CEO and senior management should set a "tone at the top" that establishes a culture of legal compliance and integrity communicated to personnel at all levels of the corporation.

An effective compliance program. Senior management should take responsibility for implementing and managing an effective compliance program relating to legal and ethical conduct. As part of its compliance program, a corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of seeking guidance and alerting management and the board about potential or actual misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

III. How the Board Performs Its Oversight Function

Publicly owned corporations employ diverse approaches to board structure and operations within the parameters of applicable legal requirements and securities market listing standards. Although no one structure is right for every corporation, Business Roundtable believes that the corporate governance "best practices" set forth in the following sections provide an effective approach for corporations to follow.

Board Composition and Leadership

■ Boards of directors of large, publicly owned corporations vary in size from industry to industry and from corporation to corporation. In determining board size, directors should consider the nature, size and complexity of the corporation as well as its stage of development. The experiences of many Business Roundtable members suggest that smaller boards often are more cohesive and work more effectively than larger boards.

■ Business Roundtable believes that having directors with relevant business and industry experience is beneficial to the board as a whole. Directors with this experience can provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business. A diversity of backgrounds and experience, consistent with the corporation's needs, also is important to the overall composition of the board. Because the corporation's need for particular backgrounds and experience may change over time, the board should monitor the mix of skills and experience that directors bring to the board against established board membership criteria to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.

■ The board of a publicly owned corporation should have a substantial degree of independence from management. Board independence depends not only on directors' individual relationships but also on the

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board's overall attitude toward management. Providing objective independent judgment is at the core of the board's oversight function, and the board's composition should reflect this principle.

- A substantial majority of directors of the board of a publicly owned corporation should be independent, both in fact and appearance, as determined by the board. In accordance with the listing standards of the major securities markets, the board should make an affirmative determination as to the independence of each director annually and should have a process in place for making these determinations.

- Definition of "independence."* An independent director should not have any relationships with the corporation or its management -- whether business, employment, charitable or personal -- that may impair, or appear to impair, the director's ability to exercise independent judgment. The listing standards of the major securities markets define "independence" and enumerate specific relationships (such as employment with the corporation or its outside auditor) that preclude a director from being considered independent.

- Assessing independence.* The board should approve standards for determining directors' independence, taking into account the requirements of the federal securities laws, securities market listing standards, and the views of institutional investors and other relevant groups. These standards should be set forth in the corporation's corporate governance principles. When considering whether a director is independent, the board should consider not only whether the director has any of the relationships covered by the board's independence standards but also whether the director has any other relationships, either directly or indirectly, with the corporation, senior management or other board members that could affect the director's actual or perceived independence.

- Relationships with not-for-profit organizations.* The board's director independence standards should include standards for assessing directors' relationships with not-for-profit organizations that receive support from the corporation. In applying these standards, the board should take into account the size of the corporation's contributions and the nature of directors' relationships to the recipient organizations. Independence issues are most likely to arise when a director is an employee of the not-for-profit organization and when a substantial portion of the organization's funding comes from the corporation. It also may be appropriate to consider contributions from a corporation's foundation to organizations with which a director is affiliated.

- Most American corporations have been well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between management and the board, ensuring that both act with a common purpose. The decision concerning whether the CEO also should serve as chairman of the board often is part of the succession planning process, and the board should make that decision in light of the corporation's facts and circumstances.

- Although no one structure is right for every corporation, it is critical that the board has independent leadership. Some boards have found it useful to separate the roles of CEO and chairman of the board. Alternatively, there is a growing trend for boards to appoint a "lead" or "presiding" director. A lead director generally advises on board meeting schedules and agendas, chairs executive sessions of the board, oversees the flow of information to the board, and serves as a liaison between the independent

directors and the CEO. The lead director also may play a key role in overseeing performance evaluations of the CEO and the board, be available for communication with shareholders, and lead the board in crisis situations.

- Still other boards have designated an independent director to preside over the executive sessions of a board's independent or nonmanagement directors that are required by securities market listing standards. Depending on the corporation, the so-called presiding director also may perform some or all of the other functions performed by the lead director.

Board Organization

- Virtually all boards of directors of large, publicly owned corporations operate using committees to assist them. A committee structure permits the board to address key areas in more depth than may be possible in a full board meeting.

- Decisions about committee membership and chairs should be made by the full board based on recommendations from the corporate governance committee. Consideration should be given to whether periodic rotation of committee memberships and chairs would provide fresh perspectives and enhance directors' familiarity with different aspects of the corporation's business, consistent with applicable listing standards.

- Committees should apprise the full board of their activities on a regular basis. Processes should be developed and monitored for keeping the board informed through oral or written reports. For example, some corporations provide minutes of committee meetings to all members of the board.

- Business Roundtable believes that the functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance. The listing standards of the major securities markets require corporations to have an audit committee that performs specific functions, and many corporations also are required to have committees that oversee executive compensation, director nominations and corporate governance matters. Business Roundtable does not believe that a particular committee structure is essential for all corporations. What is important is that key issues are addressed effectively by the independent members of the board. Thus, the references below to the functions performed by particular committees are not intended to preclude corporations from allocating these functions differently, consistent with applicable listing standards.

- Additional committees, such as finance or risk management committees, also may be used. Some corporations find it useful to establish committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- The responsibilities of each committee and the qualifications required for committee membership should be clearly defined and set out in a written charter that is approved by the board and publicly available. Each committee should review its charter annually and recommend changes to the board as appropriate.

- A more detailed discussion of particular committee functions appears in Business Roundtable's *Executive Compensation: Principles and Commentary* (November 2003) and *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004).

Audit Committee

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- Every publicly owned corporation should have an audit committee of at least three members, who should all be independent directors.

- Audit committees typically consist of three to five members. The listing standards of the major securities markets require that all members of the audit committee qualify as independent directors under applicable listing standards, subject to limited exceptions, and that they meet additional, heightened independence criteria.

- Audit committee members should meet minimum financial literacy standards, as required by the listing standards of the major securities markets, and at least one member of the audit committee should be an audit committee financial expert, as determined by the board in accordance with regulations of the Securities and Exchange Commission. Just as important is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile and to apply their business experience and judgment with an independent and critical eye to the issues for which the committee is responsible.

- With the significant responsibilities imposed on audit committees under applicable law, regulations and listing standards, consideration should be given to whether it is appropriate to limit the number of public company audit committees on which a corporation's audit committee members may serve. Some boards have adopted policies that audit committee members may not serve on the audit committees of more than three public corporations, in accordance with applicable securities market listing standards. Policies may permit exceptions to this limit when the corporation's board determines that the simultaneous service would not affect an individual's ability to serve effectively on the corporation's audit committee.

- The audit committee is responsible for supervising the corporation's relationship with its outside auditor. In performing this responsibility, the primary functions of the audit committee include:
 - Retaining the auditor and approving in advance the terms of the annual audit engagement.* The selection of the outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the outside auditor and the performance of key members of the audit team. The committee should be mindful of the schedule, mandated by applicable law and regulations, for rotating the engagement and concurring partners and should begin the process of reviewing new partners sufficiently in advance of required rotations. The audit committee also should consider periodically whether it is appropriate for the corporation to change its outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. In retaining the auditor, the audit committee should oversee the process of negotiating the annual audit engagement letter and should scrutinize the terms of the engagement carefully.

 - Overseeing the independence of the outside auditor.* The audit committee should maintain an ongoing, open dialogue with the outside auditor about independence issues. The committee should consider its overall approach to using the outside auditor as a service provider and identify those services, beyond the annual audit engagement, that the outside auditor can provide to the corporation consistent with applicable law and regulations and with maintaining independence. In pre-approving all non-audit services to be provided by the outside auditor, as required by applicable law and regulations, the

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audit committee should decide whether to adopt a pre-approval policy or approve services on an engagement-by-engagement basis.

- The audit committee also is responsible for overseeing the corporation's financial reporting process. The audit committee should review and discuss the corporation's annual financial statements with management and the outside auditor and should review the corporation's quarterly financial statements and related earnings press releases prior to issuance. As part of its reviews, the audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies, the quality of accounting judgments and estimates made by management, and any material written communications between the outside auditor and management.

- The audit committee should understand and be familiar with the corporation's system of internal controls over financial reporting and its disclosure controls and procedures, including the processes for producing the certifications required of the CEO and principal financial officer, and the audit committee should be comfortable that the corporation has appropriate controls in place. On a periodic basis, the committee should review with both the internal and outside auditors, as well as with management, the corporation's procedures for maintaining and evaluating the effectiveness of these systems. The committee should be promptly notified of any significant deficiencies or material weaknesses in internal controls and kept informed about the steps and timetable for correcting them.

- Unless the full board or another committee does so, the audit committee should oversee the corporation's program that addresses compliance with ethical and legal standards and important corporate policies, including the corporation's code of conduct and the mechanisms it has in place for employees to report compliance issues. In accordance with applicable legal requirements, the audit committee should establish procedures for receiving and handling complaints and concerns related to accounting, internal accounting controls and auditing issues, and the committee should evaluate these procedures periodically and revise them as appropriate. The audit committee should be briefed regularly on the status of outstanding compliance issues, including concerns submitted through the committee's procedures for handling accounting and related concerns, and it should receive prompt notification of any significant compliance issues.

- The audit committee should understand the corporation's risk profile and oversee its risk assessment and risk management practices.

- The audit committee should oversee the corporation's internal audit function, including reviewing the scope of the internal audit plan, reports submitted by the internal audit staff and management's response, and the appointment and replacement of the senior internal auditing executive.

- The audit committee should implement a policy covering the hiring of personnel who previously worked for the corporation's outside auditor. At a minimum, this policy should incorporate the "cooling off" period mandated by applicable law and regulations.

- Audit committee meetings should be held frequently enough to allow the committee to monitor the corporation's financial reporting appropriately. Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet privately with each of the internal and outside auditors and management on a regular basis, and in any event at least quarterly, and communicate with them between meetings as necessary. The audit committee also should hold private sessions with the corporation's chief legal officer on a regular basis to facilitate the communication of concerns regarding legal compliance matters and significant legal contingencies. The audit committee also may determine that it is appropriate to hold

private sessions with other parties, such as outside counsel, from time to time.

Corporate Governance Committee

- Every publicly owned corporation should have a committee composed solely of independent directors that addresses director nominations and corporate governance matters.
- The corporate governance committee (often combined with or referred to as a nominating committee) should have at least three members and should be composed solely of independent directors.
- The corporate governance committee recommends director nominees to the full board and the corporation's shareholders; oversees the composition, structure, operation and evaluation of the board and its committees; and plays a leadership role in shaping the corporate governance of the corporation. Depending on how the board has allocated responsibilities among its committees, the corporate governance committee also may oversee the compensation of the board if the compensation committee does not do so, or the two committees may share oversight responsibility for this area.
- In performing the core function of recommending nominees to the board, the corporate governance committee should establish criteria for board and committee membership and recommend these criteria to the board for approval. Based on these criteria, the committee should identify director candidates, review their qualifications and any potential conflicts with the corporation's interests, and recommend candidates to the board. The committee also should assess the contributions of current directors in connection with their renomination.
- In identifying director candidates, the corporate governance committee should take a proactive approach by soliciting ideas for potential candidates from a variety of sources. The committee should have the authority to retain search firms as appropriate to assist it in identifying candidates and should develop a process for considering shareholder recommendations for board nominees. Although it is appropriate for the CEO to meet with board candidates, the final responsibility for selecting director nominees should rest with the corporate governance committee and the board.
- The corporate governance committee should monitor and safeguard the independence of the board. An important function of a corporate governance committee, related to its core function of recommending nominees to the board, is to see that a substantial majority of the directors on the board meet appropriate standards of independence that are consistent with securities market listing standards and to see that these directors are independent in both fact and appearance. The corporate governance committee should develop and recommend standards of independence to the board, assess the independence of directors in light of these standards, and make recommendations to the board regarding determinations of director independence. In addition, the committee should be notified promptly of any change in a director's circumstances that may affect the director's independence.
- The corporate governance committee also recommends directors for appointment to committees of the board. The committee should periodically review the board's committee structure and annually recommend candidates for membership on the board's committees. The committee should see that the key board committees, including the audit, compensation and corporation governance committees, are composed of directors who meet applicable independence and qualification standards.
- The corporate governance committee should oversee the effective functioning of the board. The committee should review the board's policies relating to meeting schedules and agendas and the corporation's processes for providing information to the board. The corporate governance committee

should assess the reporting channels through which the board receives information and see that the board obtains appropriately detailed information in a timely fashion.

- The corporate governance committee should develop and recommend to the board a set of corporate governance principles, review them annually, and recommend changes to the board as appropriate. The corporation's corporate governance principles should be publicly available and should address, at a minimum, board leadership, qualifications for directors (including independence standards), director responsibilities, the structure and functioning of board committees, board access to management and advisers, director compensation, director orientation and continuing education, board evaluations, and management succession.

- The corporate governance committee should oversee the evaluation of the board and its committees. Specifics concerning the evaluation process are discussed under "Board and Committee Evaluation."

Compensation Committee

- Every publicly owned corporation should have a committee composed solely of independent directors that addresses compensation issues.

- The compensation committee should have at least three members and should be composed solely of independent directors. All committee members should have sufficient knowledge of executive compensation and related issues to perform their duties effectively.

- The compensation committee's responsibilities include overseeing the corporation's overall compensation structure, policies and programs; establishing or recommending to the board performance goals and objectives for the CEO and other members of senior management; and establishing or recommending to the independent directors compensation for the CEO and senior management. The compensation committee should see that the corporation's compensation policies reflect the core principle of pay for performance and should establish meaningful goals for performance-based compensation.

- The compensation committee should have the authority to retain compensation consultants, counsel and other advisers to provide the committee with independent advice.

- The compensation committee should understand all aspects of an executive's compensation package and should review and understand the maximum pay-out due under multiple scenarios (such as retirement, termination with or without cause, and severance in connection with business combinations or the sale of a business).

- The compensation committee should require senior management to build and maintain significant continuing equity investment in the corporation. The committee should establish requirements that senior management acquire and hold a meaningful amount of the corporation's stock. The committee also should consider whether to require senior management to hold for a period of time a specified amount of stock earned through incentive-based awards.

- In addition to reviewing and setting compensation for senior management, the compensation committee should look more broadly at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels. The committee should consider carefully and understand the incentives created by different forms of compensation. Incentives should further the corporation's long-term strategic plan and be consistent with the culture of

the corporation and the overall goal of enhancing enduring shareholder value.

- Executive compensation should directly link the interests of senior management, both individually and as a team, to the long-term interests of shareholders. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.
- The compensation committee should consider whether the benefits and perquisites provided to senior management are proportional to the contributions made by management.
- The compensation committee should oversee the corporation's disclosures with respect to executive compensation. In particular, the committee should use the compensation committee report included in the corporation's annual proxy statement to provide shareholders with meaningful and understandable information about the corporation's executive compensation practices.

Board Operations

- Serving on a board requires significant time and attention on the part of directors. Directors must participate in board meetings, review relevant materials, serve on board committees, and prepare for meetings and discussions with management. They must spend the time needed and meet as frequently as necessary to properly discharge their responsibilities. The appropriate number of hours to be spent by a director on his or her duties and the frequency and length of board meetings depend largely on the complexity of the corporation and its operations. Longer meetings may permit directors to explore key issues in depth, whereas shorter but more frequent meetings may help directors stay up-to-date on emerging corporate trends and business and regulatory developments. When arranging a meeting schedule for the board, each corporation should consider the nature and complexity of its operations and transactions, as well as its business and regulatory environment.
- Directors should receive incentives to focus on long-term shareholder value. Including equity as part of directors' compensation helps align the interests of directors with those of the corporation's shareholders. Accordingly, a meaningful portion of a director's compensation should be in the form of long-term equity. In this regard, corporations increasingly are providing the long-term equity component of directors' compensation in the form of restricted stock, rather than stock options, to better align directors' interests with those of shareholders. Corporations should establish a requirement that directors acquire a meaningful amount of the corporation's stock and hold that stock for as long as they remain on the board.
- Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold. However, service on too many boards can interfere with an individual's ability to satisfy his or her responsibilities, either as a member of senior management or as a director. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. It also is good practice for directors to notify the chair of the corporate governance committee for each board on which they serve before accepting a seat on the board of another corporation. Some corporations require the prior approval of the corporate governance committee. Similarly, the corporation should establish a process to review senior management service on other boards prior to acceptance.
- The board's independent or nonmanagement directors should have the opportunity to meet regularly in executive session, outside the presence of the CEO and any other management directors, in accordance with applicable listing standards.

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Time for an executive session should be placed on the agenda for every regularly scheduled board meeting.

To maximize the effectiveness of executive sessions, there should be follow-up with the CEO and other appropriate members of senior management.

■ Many board responsibilities may be delegated to committees to permit directors to address key areas in more depth. Regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from its committees, committees should keep the full board informed of their activities. Corporations benefit greatly from the collective wisdom of the entire board acting as a deliberative body, and the interaction between committees and the full board should reflect this principle.

■ The board's agenda must be carefully planned yet flexible enough to accommodate emergencies and unexpected developments. The chairman of the board should work with the lead director (when the corporation has one) in setting the agenda and should be responsive to individual directors' requests to add items to the agenda and open to suggestions for improving the agenda. It is important that the agenda and meeting schedule permit adequate time for discussion and a healthy give-and-take between board members and management.

■ Board agendas should be structured to allow time for open discussion. Board members should have full access to senior management.

■ The board must have accurate, complete information to do its job; the quality of information received by the board directly affects its ability to perform its oversight function effectively. Directors should receive and review information from a variety of sources, including management, board committees, outside experts, auditor presentations, and analyst and media reports. The board should be provided with information before board and committee meetings, with sufficient time to review and reflect on key issues and to request supplemental information as necessary.

■ Corporations should have an orientation process for new directors that is designed to familiarize them with the corporation's business, industry and corporate governance practices. Common practices include briefings from senior management, on-site visits to the corporation's facilities, informal meetings with other directors and written materials. Corporations also should encourage directors to take advantage of educational opportunities on an ongoing basis to enable them to better perform their duties and to keep informed about developments in areas such as the corporation's industry, corporate governance and director responsibilities.

■ Where appropriate, boards and board committees should seek advice from outside advisers independent of management with respect to matters within their responsibility. For example, there may be technical aspects of the corporation's business -- such as risk assessment and risk management -- or conflict of interest situations for which the board or a committee determines that additional expert advice would be useful. Similarly, many compensation committees engage their own compensation consultants. The board and its committees should have the authority to select and retain advisers and approve the terms of their retention and fees.

Management Development and Succession

■ Long-term planning for CEO and senior management development and succession is one of the

board's most important functions. The board, its corporate governance committee or another committee of independent directors should identify and regularly update the qualities and characteristics necessary for an effective CEO. With these principles in mind, the board or committee should periodically monitor and review the development and progression of potential internal candidates against these standards.

- Emergency succession planning also is critical. Working with the CEO, the board or committee should see that plans are in place for contingencies such as the departure, death or disability of the CEO or other members of senior management to facilitate the transition to both interim and longer term leadership in the event of an untimely vacancy.

- Under the oversight of an independent committee or the lead director, the board should annually review the performance of the CEO and participate with the CEO in the evaluation of members of senior management. All nonmanagement members of the board should participate with the CEO in senior management evaluations. The results of the CEO's evaluation should be promptly communicated to the CEO in executive session by representatives of the independent directors and used by the compensation committee or board in determining the CEO's compensation.

Board and Committee Evaluation

- The board should have an effective mechanism for evaluating performance on a continuing basis. Meaningful board evaluation requires an assessment of the effectiveness of the full board, the operations of board committees and the contributions of individual directors.

- For some companies, securities market listing standards now require that the board and its audit, compensation and corporate governance committees conduct annual evaluations. Regardless of whether an evaluation is required, the performance of the full board should be evaluated annually, as should the performance of its committees. The board should use the annual self-evaluation to assess whether it is following the procedures necessary to function effectively. Each board committee should conduct an annual self-evaluation to assess its effectiveness, and the results of this evaluation should be reported to the full board.

- The board should have a process for evaluating whether the individuals sitting on the board bring the skills and expertise appropriate for the corporation and how they work as a group. Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board, and a director's ability to continue to contribute to the board should be examined by the corporate governance committee each time the director is considered for renomination.

- Planning for the departure of directors and the designation of new board members is essential. The board should plan ahead for changes in membership, and it should have written criteria for director candidates that should be re-evaluated periodically. The board also should establish procedures for the retirement or replacement of board members. These procedures may, for example, include a mandatory retirement age, a term limit and/or a requirement that directors who change their primary employment tender a board resignation, providing an opportunity for the governance committee to consider the desirability of their continued service on the board.

IV. Relationships with Shareholders and Other Constituencies

Corporations are often said to have obligations to shareholders and other constituencies, including employees, the communities in which they do business and government, but these obligations are best viewed as part of the paramount duty to optimize long-term shareholder value. Business Roundtable believes that shareholder value is enhanced when a corporation treats its employees well, serves its customers well, fosters good relationships with suppliers, maintains an effective compliance program and strong corporate governance practices, and has a reputation for civic responsibility.

Shareholders and Investors

- Corporations have a responsibility to communicate effectively and candidly with shareholders. The goal of shareholder communications should be to help shareholders understand the business, risk profile, financial condition and operating performance of the corporation and the board's corporate governance practices.

- Corporations communicate with investors and other constituencies not only in proxy statements, annual and other reports, and formal shareholder meetings, but in many other ways as well. All of these communications should provide consistency, clarity and candor.

- Corporations should have effective procedures for shareholders to communicate with the board and for directors to respond to shareholder concerns. The board, or an independent committee such as the corporate governance committee, should establish, oversee and regularly review and update these procedures as appropriate.

- The board should respond in a timely manner to substantive communications from shareholders, and when appropriate, directors should meet with shareholders regarding issues of concern.

- A corporation's procedures for shareholder communications and its governance practices should be readily available to shareholders. Information about the board's structure and operations, committee composition and responsibilities, corporate governance principles, and codes of ethics should be widely disseminated to shareholders.

- The board should be notified of shareholder proposals, and the board or its corporate governance committee should oversee the corporation's response to these proposals.

- Directors should attend the corporation's annual meeting of shareholders, and the corporation should have a policy requiring attendance absent unusual circumstances. Time at the annual meeting should be set aside for shareholders to submit questions and for management or directors to respond to those questions.

- The board should seriously consider issues raised by shareholder proposals that receive substantial support and should communicate its response to proposals to the shareholder-proponents and to all shareholders.

- The board should respond appropriately when a director nominee receives a significant "withhold" or "against" vote with respect to his or her election to the board. The corporate governance committee should assess the reasons for the vote and recommend to the board the action to be taken with respect to the vote, which should be communicated to the corporation's shareholders.

- In planning communications with shareholders and investors, corporations should consider:

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Candor. Directors and management should never mislead or misinform shareholders about the corporation's operations or financial condition.

Need for timely disclosure. In an age of instant communication, corporations increasingly are disclosing significant information closer to the time when it arises and becomes available. Business Roundtable supports prompt disclosure of significant developments.

Use of technology. Technology makes communicating quicker, easier and less expensive. Corporations should take advantage of technological advances to enhance the dissemination of information to shareholders and employees.

Ultimate goal of shareholder communications. Whatever the substance of the communication, the corporation's ultimate goal should be to furnish information that is honest, intelligible, meaningful, timely and broadly disseminated and that gives investors a realistic picture of the corporation's financial condition and results of operations through the eyes of management.

Employees

- It is in a corporation's best interest to treat employees fairly and equitably.
- Corporations should have in place policies and practices that provide employees with compensation, including benefits, that is appropriate given the nature of the corporation's business and employees' job responsibilities and geographic locations.
- When corporations offer retirement, health care, insurance and other benefit plans, employees should be fully informed of the terms of those plans.
- Corporations should have in place and publicize mechanisms for employees to seek guidance and to alert management and the board about potential or actual misconduct without fear of retribution.
- Corporations should communicate honestly with their employees about corporate operations and financial performance.

Communities

- Corporations have obligations to be good citizens of the local, national and international communities in which they do business. Failure to meet these obligations can result in damage to the corporation, both in immediate economic terms and in longer-term reputational value.
- A corporation should be a good citizen and contribute to the communities in which it operates by making charitable contributions and encouraging its directors, managers and employees to form relationships with those communities. A corporation also should be active in promoting awareness of health, safety and environmental issues, including any issues that relate to the specific types of business in which the corporation is engaged.

Government

- Corporations, like all citizens, must act within the law. The penalties for serious violations of law can be extremely severe, even life-threatening, for corporations. Compliance is not only appropriate -- it is essential. Management should take reasonable steps to develop, implement and maintain an effective legal compliance program, and the board should be knowledgeable about and oversee the program, including periodically reviewing the program to gain reasonable assurance that it is effective in deterring and preventing misconduct.

- Corporations have an important perspective to contribute to the public policy dialogue and should be actively involved in discussions about the development, enactment and revision of the laws and regulations that affect their businesses and the communities in which they operate and their employees reside.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice Appendix B.syn

§ B.syn Synopsis to Appendix B: NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

Appendix B Scope

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§ 303A.01 Independent Directors

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§ 303A.11 Foreign Private Issuer Disclosure

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Corporate Governance: Law and Practice

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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice Appendix B

Scope

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NYSE Listed Company Manual § 303A



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2-B Corporate Governance: Law and Practice § 303A.00

Introduction

General Application

Companies listed on the Exchange must comply with certain standards regarding corporate governance as codified in this Section 303A. Consistent with the NYSE's traditional approach, as well as the requirements of the Sarbanes-Oxley Act of 2002, certain provisions of Section 303A are applicable to some listed companies but not to others.

Equity Listings

Section 303A applies in full to all companies listing common equity securities, with the following exceptions:

Controlled Companies

A listed company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with the requirements of Sections 303A.01, 303A.04 or 303A.05. A controlled company that chooses to take advantage of any or all of these exemptions must disclose that choice, that it is a controlled company and the basis for the determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Controlled companies must comply with the remaining provisions of Section 303A.

Limited Partnerships and Companies in Bankruptcy

Due to their unique attributes, limited partnerships and companies in bankruptcy proceedings need not comply with the requirements of Sections 303A.01, 303A.04 or 303A.05. However, all limited partnerships (at the general partner level) and companies in bankruptcy proceedings must comply with the remaining provisions of Section 303A.

Closed-End and Open-End Funds

The Exchange considers the significantly expanded standards and requirements provided for in Section 303A to be unnecessary for closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940, given the pervasive federal regulation applicable to them. However, closed-end funds must

comply with the requirements of Sections 303A.06, 303A.07(a) and 303A.07(c), and 303A.12. Note, however, that in view of the common practice to utilize the same directors for boards in the same fund complex, closed-end funds will not be required to comply with the disclosure requirement in the second paragraph of the Commentary to 303A.07(a), which calls for disclosure of a board's determination with respect to simultaneous service on more than three public company audit committees. However, the other provisions of that paragraph will apply.

Business development companies, which are a type of closed-end management investment company defined in Section 2(a)(48) of the Investment Company Act of 1940 that are not registered under that Act, are required to comply with all of the provisions of Section 303A applicable to domestic issuers other than Sections 303A.02 and 303A.07(b). For purposes of Sections 303A.01, 303A.03, 303A.04, 303A.05, and 303A.09, a director of a business development company shall be considered to be independent if he or she is not an "interested person" of the company, as defined in Section 2(a)(19) of the Investment Company Act of 1940.

As required by Rule 10A-3 under the Exchange Act, open-end funds (which can be listed as Investment Company Units, more commonly known as Exchange Traded Funds or ETFs) are required to comply with the requirements of Sections 303A.06 and 303A.12(b) and (c).

Rule 10A-3(b)(3)(ii) under the Exchange Act requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. In view of the external management structure often employed by closed-end and open-end funds, the Exchange also requires the audit committees of such companies to establish such procedures for the confidential, anonymous submission by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the management company, as well as employees of the management company. This responsibility must be addressed in the audit committee charter.

Other Entities

Except as otherwise required by Rule 10A-3 under the Exchange Act (for example, with respect to open-end funds), Section 303A does not apply to passive business organizations in the form of trusts (such as royalty trusts) or to derivatives and special purpose securities (such as those described in Sections 703.16, 703.19, 703.20 and 703.21). To the extent that Rule 10A-3 applies to a passive business organization, listed derivative or special purpose security, such entities are required to comply with Sections 303A.06 and 303A.12(b).

Foreign Private Issuers

Listed companies that are foreign private issuers (as such term is defined in Rule 3b-4 under the Exchange Act) are permitted to follow home country practice in lieu of the provisions of this Section 303A, except that such companies are required to comply with the requirements of Sections 303A.06, 303A.11 and 303A.12(b) and (c).

Preferred and Debt Listings

Section 303A does not generally apply to companies listing only preferred or debt securities on the Exchange. To the extent required by Rule 10A-3 under the Exchange Act, all companies listing only preferred or debt securities on the NYSE are required to comply with the requirements of Sections 303A.06 and 303A.12(b) and (c).

Effective Dates/Transition Periods

Except for Section 303A.08, which became effective June 30, 2003, listed companies will have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new standards contained in Section 303A, although if a listed company with a classified board would be required (other than by virtue of a requirement

under Section 303A.06) to change a director who would not normally stand for election in such annual meeting, the listed company may continue such director in office until the second annual meeting after such date, but no later than December 31, 2005. In addition, foreign private issuers will have until July 31, 2005 to comply with the new audit committee standards set out in Section 303A.06, and will not be required to provide the written affirmations required by Section 303A.12(c) until after that date. As a general matter, the existing audit committee requirements provided for in Section 303 continue to apply to listed companies pending the transition to the new rules. On November 3, 2004, the SEC approved a change to the Section 303A.02(b)(iii) bright line test for director independence relating to audit firms. Companies will have until their first annual meeting after June 30, 2005, to replace a director who was independent under the prior test but who is not independent under the current test.

Companies listing in conjunction with their initial public offering will be permitted to phase in their independent nomination and compensation committees on the same schedule as is permitted pursuant to Rule 10A-3 under the Exchange Act for audit committees, that is, one independent member at the time of listing, a majority of independent members within 90 days of listing and fully independent committees within one year. Such companies will be required to meet the majority independent board requirement within 12 months of listing. For purposes of Section 303A other than Sections 303A.06 and 303A.12(b), a company will be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act. The Exchange will also permit companies that are emerging from bankruptcy or have ceased to be controlled companies within the meaning of Section 303A to phase in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with an initial public offering. However, for purposes of Sections 303A.06 and 303A.12(b), a company will be considered to be listing in conjunction with an initial public offering only if it meets the conditions of Rule 10A-3(b)(1)(iv)(A) under the Exchange Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act.

Companies listing upon transfer from another market have 12 months from the date of transfer in which to comply with any requirement to the extent the market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also had a transition period from the effective date of that market's rule, which period had not yet expired, the company will have the same transition period as would have been available to it on the other market. This transition period for companies transferring from another market will not apply to the requirements of Section 303A.06 unless a transition period is available pursuant to Rule 10A-3 under the Exchange Act.

References to Form 10-K

There are provisions in this Section 303A that call for disclosure in a listed company's Form 10-K under certain circumstances. If a listed company subject to such a provision is not a company required to file a Form 10-K, then the provision shall be interpreted to mean the annual periodic disclosure form that the listed company does file with the SEC. For example, for a closed-end management company, the appropriate form would be the annual Form N-CSR. If a listed company is not required to file either an annual proxy statement or an annual periodic report with the SEC, the disclosure shall be made in the annual report required under Section 203.01 of the NYSE Listed Company Manual.



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2-B Corporate Governance: Law and Practice § 303A.01

Independent Directors

Listed companies must have a majority of independent directors.

Commentary: Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.



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2-B Corporate Governance: Law and Practice § 303A.02

Independence Tests

In order to tighten the definition of "independent director" for purposes of these standards:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company (references to "company" would include any parent or subsidiary in a consolidated group with the company). Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the listed company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The identity of the independent directors and the basis for a board determination that a relationship is not material must be disclosed in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination in the manner described above. This approach provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer,ⁿ¹ of the listed company.

Commentary: Employment as an interim Chairman or CEO or other executive officer shall not disqualify a director from being considered independent following that employment.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

Commentary: Compensation received by a director for former service as an interim Chairman or CEO or other executive officer need not be considered in determining independence under this test. Compensation received by an immediate family member for service as an employee of the listed company (other than an executive officer) need not be considered in determining independence under this test.

(iii) (A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues.

Commentary: In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

Contributions to tax exempt organizations shall not be considered "payments" for purposes of Section 303A.02(b)(v), provided however that a listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any such contributions made by the listed company to any tax exempt organization in which any independent director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year from the listed company to the organization exceeded the greater of \$1 million, or 2% of such tax exempt organization's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

General Commentary to Section 303A.02(b): An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other

than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated. In addition, references to the "company" would include any parent or subsidiary in a consolidated group with the company.

Transition Rule. Each of the above standards contains a three-year "look-back" provision. In order to facilitate a smooth transition to the new independence standards, the Exchange will phase in the "look-back" provisions by applying only a one-year look-back for the first year after adoption of these new standards. The three-year look-backs provided for in Section 303A.02(b) will begin to apply only from and after November 4, 2004.

As an example, until November 3, 2004, a company need look back only one year when testing compensation under Section 303A.02(b)(ii). Beginning November 4, 2004, however, the company would need to look back the full three years provided in Section 303A.02(b)(ii).

FOOTNOTES:

(n3)Footnote 1. For purposes of Section 303A, the term "executive officer" has the same meaning specified for the term "officer" in Rule 16-1(f) under the Securities Exchange Act of 1934.



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2-B Corporate Governance: Law and Practice § 303A.03

Executive Sessions

To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.

Commentary: To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. "Non-management" directors are all those who are not executive officers, and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.

Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. A non-management director must preside over each executive session of the non-management directors, although the same director is not required to preside at all executive sessions of the non-management directors. If one director is chosen to preside at all of these meetings, his or her name must be disclosed in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Alternatively, if the same individual is not the presiding director at every meeting, a listed company must disclose the procedure by which a presiding director is selected for each executive session. For example, a listed company may wish to rotate the presiding position among the chairs of board committees.

In order that interested parties may be able to make their concerns known to the non-management directors, a listed company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group. Such disclosure must be made in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Companies may, if they wish, utilize for this purpose the same procedures they have established to comply with the requirement of Rule 10A-3 (b)(3) under the Exchange Act, as applied to listed companies through Section 303A.06.

While this Section 303A.03 refers to meetings of non-management directors, if that group includes directors who are not independent under this Section 303A, listed companies should at least once a year schedule an executive session including only independent directors.



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2-B Corporate Governance: Law and Practice § 303A.04

Nominating/Corporate Governance Committee

(a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.

(b) The nominating/corporate governance committee must have a written charter that addresses:

(i) the committee's purpose and responsibilities - which, at minimum, must be to: identify individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; develop and recommend to the board a set of corporate governance guidelines applicable to the corporation; and oversee the evaluation of the board and management; and

(ii) an annual performance evaluation of the committee.

Commentary: A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

If a listed company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (for example, preferred stock rights to elect directors upon a dividend default, shareholder agreements, and management agreements), the selection and nomination of such directors need not be subject to the nominating committee process.

The nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.

Boards may allocate the responsibilities of the nominating/corporate governance committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.



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Compensation Committee

(a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

(i) the committee's purpose and responsibilities - which, at minimum, must be to have direct responsibility to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and

(B) make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval; and

(C) produce a compensation committee report on executive officer compensation as required by the SEC to be included in the listed company's annual proxy statement or annual report on Form 10-K filed with the SEC;

(ii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the listed company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with or without ratification of the board) as may be required to comply with applicable tax laws (i.e., Rule 162(m)). Note also that nothing in Section 303A.05(b)(i)(B) is intended to preclude the board from delegating its authority over such matters to the compensation committee.

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

Boards may allocate the responsibilities of the compensation committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

Nothing in this provision should be construed as precluding discussion of CEO compensation with the board generally, as it is not the intent of this standard to impair communication among members of the board.



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2-B Corporate Governance: Law and Practice § 303A.06

Audit Committee

Listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act.

Commentary: The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the Exchange will provide companies the opportunity to cure defects provided in Rule 10A-3(a)(3) under the Exchange Act.



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Audit Committee Additional Requirements

(a) The audit committee must have a minimum of three members.

Commentary: Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(h) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve to three or less, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

(b) In addition to any requirement of Rule 10A-3(b)(1), all audit committee members must satisfy the requirements for independence set out in Section 303A.02.

(c) The audit committee must have a written charter that addresses:

(i) the committee's purpose - which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the listed company's financial statements, (2) the listed company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the listed company's internal audit function and independent auditors; and

(B) prepare an audit committee report as required by the SEC to be included in the listed company's annual proxy statement;

(ii) an annual performance evaluation of the audit committee; and

(iii) the duties and responsibilities of the audit committee - which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act, as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the listed company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the company's specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations";

(C) discuss the listed company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

Commentary: The audit committee's responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a listed company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;

Commentary: While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for

the internal audit function) and with independent auditors;

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(F) review with the independent auditor any audit problems or difficulties and management's response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the listed company. The review should also include discussion of the responsibilities, budget and staffing of the listed company's internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(H) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the listed company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

General Commentary to Section 303A.07(c): While the fundamental responsibility for the listed company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the listed company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma" or "adjusted" non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

(d) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A

listed company may choose to outsource this function to a third party service provider other than its independent auditor.

General Commentary to Section 303A.07: To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.



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Corporate Governance: Law and Practice

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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.08

Shareholder Approval of Equity Compensation Plans

Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions explained below.

Equity-compensation plans can help align shareholder and management interests, and equity-based awards are often very important components of employee compensation. To provide checks and balances on the potential dilution resulting from the process of earmarking shares to be used for equity-based awards, the Exchange requires that all equity-compensation plans, and any material revisions to the terms of such plans, be subject to shareholder approval, with the limited exemptions explained below.

Definition of Equity-Compensation Plan

An "equity-compensation plan" is a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services. Even a compensatory grant of options or other equity securities that is not made under a plan is, nonetheless, an "equity-compensation plan" for these purposes. However, the following are not "equity-compensation plans" even if the brokerage and other costs of the plan are paid for by the listed company:

- Plans that are made available to shareholders generally, such as a typical dividend reinvestment plan.
- Plans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, regardless of whether:
 - the shares are delivered immediately or on a deferred basis; or
 - the payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

Material Revisions

A "material revision" of an equity-compensation plan includes (but is not limited to), the

following:

- A material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction).

-- If a plan contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula") or for automatic grants pursuant to a formula, each such increase or grant will be considered a revision requiring shareholder approval unless the plan has a term of not more than ten years.

This type of plan (regardless of its term) is referred to below as a "formula plan." Examples of automatic grants pursuant to a formula are (1) annual grants to directors of restricted stock having a certain dollar value, and (2) "matching contributions," whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer.

-- If a plan contains no limit on the number of shares available and is not a formula plan, then each grant under the plan will require separate shareholder approval regardless of whether the plan has a term of not more than ten years.

This type of plan is referred to below as a "discretionary plan." A requirement that grants be made out of treasury shares or repurchased shares will not, in itself, be considered a limit or pre-established formula so as to prevent a plan from being considered a discretionary plan.

- An expansion of the types of awards available under the plan.
- A material expansion of the class of employees, directors or other service providers eligible to participate in the plan.
- A material extension of the term of the plan.
- A material change to the method of determining the strike price of options under the plan.

-- A change in the method of determining "fair market value" from the closing price on the date of grant to the average of the high and low price on the date of grant is an example of a change that the Exchange would not view as material.

- The deletion or limitation of any provision prohibiting repricing of options. See the next section for details.

Note that an amendment will not be considered a "material revision" if it curtails rather than expands the scope of the plan in question.

Repricings

A plan that does not contain a provision that specifically permits repricing of options will be considered for purposes of this listing standard as prohibiting repricing. Accordingly any actual repricing of options will be considered a material revision of a plan even if the plan itself is not revised. This consideration will not apply to a repricing through an exchange offer that commenced before the date this listing standard became effective.

"Repricing" means any of the following or any other action that has the same effect:

- Lowering the strike price of an option after it is granted.
- Any other action that is treated as a repricing under generally accepted accounting principles.
- Canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction.

Exemptions

This listing standard does not require shareholder approval of employment inducement awards, certain grants, plans and amendments in the context of mergers and acquisitions, and certain specific types of plans, all as described below. However, these exempt grants, plans and amendments may be made only with the approval of the company's independent compensation committee or the approval of a majority of the company's independent directors. Companies must also notify the Exchange in writing when they use one of these exemptions.

Employment Inducement Awards

An employment inducement award is a grant of options or other equity-based compensation as a material inducement to a person or persons being hired by the listed company or any of its subsidiaries, or being rehired following a bona fide period of interruption of employment. Inducement awards include grants to new employees in connection with a merger or acquisition. Promptly following a grant of any inducement award in reliance on this exemption, the listed company must disclose in a press release the material terms of the award, including the recipient(s) of the award and the number of shares involved.

Mergers and Acquisitions

Two exemptions apply in the context of corporate acquisitions and mergers.

First, shareholder approval will not be required to convert, replace or adjust outstanding options or other equity-compensation awards to reflect the transaction.

Second, shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exemption applies to situations where a party that is not a listed company following the transaction has shares available for grant under pre-existing plans that were previously approved by shareholders. A plan adopted in contemplation of the merger or acquisition transaction would not be considered "pre-existing" for purposes of this exemption.

Shares available under such a pre-existing plan may be used for post-transaction grants of options and other awards with respect to equity of the entity that is the listed company after the transaction, either under the pre-existing plan or another plan, without further shareholder approval, so long as:

- the number of shares available for grants is appropriately adjusted to reflect the transaction;
- the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and
- the options and other awards are not granted to individuals who were employed, immediately before

the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction.

Any shares reserved for listing in connection with a transaction pursuant to either of these exemptions would be counted by the Exchange in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock and thus required shareholder approval under Listed Company Manual Section 312.03(c).

These merger-related exemptions will not result in any increase in the aggregate potential dilution of the combined enterprise. Further, mergers or acquisitions are not routine occurrences, and are not likely to be abused. Therefore, the Exchange considers both of these exemptions to be consistent with the fundamental policy involved in this standard.

Qualified Plans, Parallel Excess Plans and Section 423 Plans

The following types of plans (and material revisions thereto) are exempt from the shareholder approval requirement:

- plans intended to meet the requirements of *Section 401(a) of the Internal Revenue Code* (e.g., ESOPs);
- plans intended to meet the requirements of *Section 423 of the Internal Revenue Code*; and
- "parallel excess plans" as defined below.

Section 401(a) plans and Section 423 plans are already regulated under the Internal Revenue Code and Treasury regulations. Section 423 plans, which are stock purchase plans under which an employee can purchase no more than \$25,000 worth of stock per year at a plan-specified discount capped at 15%, are also required by the Internal Revenue Code to receive shareholder approval. While Section 401(a) plans and parallel excess plans are not required to be approved by shareholders, U.S. GAAP requires that the shares issued under these plans be "expensed" (i.e., treated as a compensation expense on the income statement) by the company issuing the shares.

An equity-compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable Section 401(a) plan, Section 423 plan or parallel excess plan that the listed company provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, are also exempt from shareholder approval under this section.

The term "parallel excess plan" means a plan that is a "pension plan" within the meaning of the Employee Retirement Income Security Act ("ERISA") that is designed to work in parallel with a plan intended to be qualified under *Internal Revenue Code Section 401(a)* to provide benefits that exceed the limits set forth in *Internal Revenue Code Section 402(g)* (the section that limits an employee's annual pre-tax contributions to a 401(k) plan), *Internal Revenue Code Section 401(a)(17)* (the section that limits the amount of an employee's compensation that can be taken into account for plan purposes) and/or *Internal Revenue Code Section 415* (the section that limits the contributions and benefits under qualified plans) and/or any successor or similar limitations that may hereafter be enacted. A plan will not be considered a parallel excess plan unless (1) it covers all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit of Code Section 401(a)(17) (or any successor or similar limits that may hereafter be enacted); (2) its terms are substantially the same as the qualified plan that it parallels except for the elimination of the limits described in the preceding sentence and the limitation described in clause (3); and (3) no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation.

Transition Rules

Except as provided below, a plan that was adopted before the date of the Securities and Exchange Commission order approving this listing standard will not be subject to shareholder approval under this listing standard unless and until it is materially revised.

In the case of a discretionary plan (as defined in "Material Revisions" above), whether or not previously approved by shareholders, additional grants may be made after the effective date of this listing standard without further shareholder approval only for a limited transition period, defined below, and then only in a manner consistent with past practice. See also "Material Revisions" above. In applying this rule, if a plan can be separated into a discretionary plan portion and a portion that is not discretionary, the non-discretionary portion of the plan can continue to be used separately, under the appropriate transition rule. For example, if a shareholder-approved plan permits both grants pursuant to a provision that makes available a specific number of shares, and grants pursuant to a provision authorizing the use of treasury shares without regard to the specific share limit, the former provision (but not the latter) may continue to be used after the transition period, under the general rule above.

Similarly, in the case of a formula plan (as defined in "Material Revisions" above) that either (1) has not previously been approved by shareholders or (2) does not have a term of ten years or less, additional grants may be made after the effective date of this listing standard without further shareholder approval only for a limited transition period, defined below.

The limited transition period described in the preceding two paragraphs will end upon the first to occur of:

- the listed company's next annual meeting at which directors are elected that occurs more than 180 days after the effective date of this listing standard;
- the first anniversary of the effective date of this listing standard; and
- the expiration of the plan.

A shareholder-approved formula plan may continue to be used after the end of this transition period if it is amended to provide for a term of ten years or less from the date of its original adoption or, if later, the date of its most recent shareholder approval. Such an amendment may be made before or after the effective date of this listing standard, and would not itself be considered a "material revision" requiring shareholder approval.

In addition, a formula plan may continue to be used, without shareholder approval, if the grants after the effective date of this listing standard are made only from the shares available immediately before the effective date, in other words, based on formulaic increases that occurred prior to such effective date.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.09

Corporate Governance Guidelines

Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every listed company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each listed company's website must include its corporate governance guidelines and the charters of its most important committees (including at least the audit, and if applicable, compensation and nominating committees). The listed company must state in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the listed company's policies and procedures, as well as more conscientious adherence to them by directors and management.

The following subjects must be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in Sections 303A.01 and 303A.02. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.
- **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.
- **Director access to management and, as necessary and appropriate, independent advisors.**
- **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the

listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.

- **Director orientation and continuing education.**

- **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.

- **Annual performance evaluation of the board.** The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.10

Code of Business Conduct and Ethics

Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

Commentary: No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the listed company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code. Each listed company's website must include its code of business conduct and ethics. The listed company must state in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, that the foregoing information is available on its website and that the information is available in print to any shareholder who requests it.

Each listed company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A "conflict of interest" occurs when an individual's private interest interferes in any way - or even appears to interfere - with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such

persons are of special concern. The listed company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the listed company.

■ **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

■ **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the listed company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.

■ **Fair dealing.** Each employee, officer and director should endeavor to deal fairly with the company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice. Listed companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as "at will" employment arrangements.

■ **Protection and proper use of company assets.** All employees, officers and directors should protect the company's assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the listed company's profitability. All company assets should be used for legitimate business purposes.

■ **Compliance with laws, rules and regulations (including insider trading laws).** The listed company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.

■ **Encouraging the reporting of any illegal or unethical behavior.** The listed company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the listed company must ensure that employees know that the company will not allow retaliation for reports made in good faith.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.11

Foreign Private Issuer Disclosure

Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Commentary: Foreign private issuers must make their U.S. investors aware of the significant ways in which their corporate governance practices differ from those required of domestic companies under NYSE listing standards. However, foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country's corporate governance practices are better or more effective than another. The Exchange believes that U.S. shareholders should be aware of the significant ways that the governance of a listed foreign private issuer differs from that of a U.S. listed company. The Exchange underscores that what is required is a brief, general summary of the significant differences, not a cumbersome analysis.

Listed foreign private issuers may provide this disclosure either on their web site (provided it is in the English language and accessible from the United States) and/or in their annual report as distributed to shareholders in the United States in accordance with Sections 103.00 and 203.01 of the Listed Company Manual (again, in the English language). If the disclosure is only made available on the web site, the annual report shall so state and provide the web address at which the information may be obtained.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.12

Certification Requirements

(a) Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.

Commentary: The CEO's annual certification regarding the NYSE's corporate governance listing standards will focus the CEO and senior management on the listed company's compliance with the listing standards. Both this certification to the NYSE, including any qualifications to that certification, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the listed company's public disclosure, must be disclosed in the company's annual report to shareholders or, if the company does not prepare an annual report to shareholders, in the company's annual report on Form 10-K filed with the SEC.

(b) Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303A.

(c) Each listed company must submit an executed Written Affirmation annually to the NYSE. In addition, each listed company must submit an interim Written Affirmation each time a change occurs to the board or any of the committees subject to Section 303A. The annual and interim Written Affirmations must be in the form specified by the NYSE.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.13

Public Reprimand Letter

The NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard.

Commentary: Suspending trading in or delisting a listed company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. For this reason it is appropriate for the NYSE to have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards. Accordingly, the NYSE may issue a public reprimand letter to any listed company, regardless of type of security listed or country of incorporation, that it determines has violated a NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties. For clarification, this lesser sanction is not intended for use in the case of companies that fall below the financial and other continued listing standards provided in Chapter 8 of the Listed Company Manual or that fail to comply with the audit committee standards set out in Section 303A.06. The processes and procedures provided for in Chapter 8 govern the treatment of companies falling below those standards.



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Appendix B NYSE CORPORATE GOVERNANCE STANDARDS, NYSE LISTED COMPANY MANUAL § 303A

2-B Corporate Governance: Law and Practice § 303A.14

Website Requirement

Listed companies must have and maintain a publicly accessible website.

Commentary: To the extent that a listed company is subject to the requirements of Sections 303A.04, .05, .07(c), .09 or .10, each listed company's website must include a printable version of the applicable charters of its compensation, nominating and audit committees, as well as its corporate governance guidelines and code of business conduct and ethics. In addition, a listed company that is a foreign private issuer is required to include the disclosure required by Section 303A.11 on its website in the English language and such website must be accessible from the United States.

In the case of a listed company that is a closed-end fund, if the company does not maintain its own website, the company may utilize a website that the company is allowed to use to satisfy the website posting requirement in Exchange Act Rule 16a-3(k).



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Appendix C SELECTED NASDAQ ("Marketplace") RULES: * NASDAQ RULE 4200(a)(15); IM 4200; NASDAQ
RULE 4350; IM 4350-4; IM 4350-5; IM 4350-7

2-C Corporate Governance: Law and Practice Appendix C.syn

**§ C.syn Synopsis to Appendix C: SELECTED NASDAQ ("Marketplace") RULES: * NASDAQ RULE
4200(a)(15); IM 4200; NASDAQ RULE 4350; IM 4350-4; IM 4350-5; IM 4350-7**

NASDAQ Rule 4200. DEFINITIONS



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Appendix C SELECTED NASDAQ ("Marketplace") RULES: * NASDAQ RULE 4200(a)(15); IM 4200; NASDAQ
RULE 4350; IM 4350-4; IM 4350-5; IM 4350-7

2-C Corporate Governance: Law and Practice

NASDAQ Rule 4200. DEFINITIONS

(a) For purposes of the Rule 4000 Series, unless the context requires otherwise:

...

(15) "Independent director" means a person other than an executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer's board of directors, would interfere with the exercise of independent judgement in carrying out the responsibilities of a director. The following persons shall not be considered independent:

(A) a director who is, or at any time during the past three years was, employed by the company;

(B) a director who accepted or who has a Family Member who accepted any compensation from the company in excess of \$100,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:

(i) compensation for board or board committee service;

(ii) benefits under a tax-qualified retirement plan, or non-discretionary compensation

(iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 4350(d).

(C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company as an executive officer;

(D) a director who is, or has a Family Member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or

services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, other than the following:

- (i) payments arising solely from investments in the company's securities; or
- (ii) payments under non-discretionary charitable contribution matching programs.

(E) a director of the issuer who is, or has a Family Member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the issuer serve on the compensation committee of such other entity; or

(F) a director who is, or has a Family Member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.

(G) in the case of an investment company, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

[Adopted by SEC Release 34-53128 (Jan. 13, 2006). Amended by SR-NASDAQ-2006-007 eff. May 8, 2006. Amended by SR-NASDAQ-2006-021 eff. Oct. 6, 2006. Amended by SR-NASDAQ-2006-041 eff. Mar. 13, 2007. Amended by SR-NASDAQ-2006-032 eff. Apr 18, 2007.]

IM-4200. DEFINITION OF INDEPENDENCE--RULE 4200(A)(15)

It is important for investors to have confidence that individuals serving as independent directors do not have a relationship with the listed company that would impair their independence. The board has a responsibility to make an affirmative determination that no such relationships exist through the application of Rule 4200. Rule 4200 also provides a list of certain relationships that preclude a board finding of independence. These objective measures provide transparency to investors and companies, facilitate uniform application of the rules, and ease administration. Because Nasdaq does not believe that ownership of company stock by itself would preclude a board finding of independence, it is not included in the aforementioned objective factors. It should be noted that there are additional, more stringent requirements that apply to directors serving on audit committees, as specified in Rule 4350.

The Rule's reference to the "company" includes any parent or subsidiary of the company. The term "parent or subsidiary" is intended to cover entities the issuer controls and consolidates with the issuer's financial statements as filed with the Commission (but not if the issuer reflects such entity solely as an investment in its financial statements). The reference to executive officer means those officers covered in SEC Rule 16a-1(f) under the Act. In the context of the definition of Family Member under Rule 4200(a)(14), the reference to marriage is intended to capture relationships specified in the Rule (parents, children and siblings) that arise as a result of marriage, such as "in-law" relationships.

The three year look-back periods referenced in paragraphs (A), (C), (E) and (F) of the Rule commence on the date the relationship ceases. For example, a director employed by the company is not independent until three years after such employment terminates.

For purposes of paragraph (A) of the Rule, employment by a director as an executive officer on an interim basis shall not disqualify that director from being considered independent following such employment, provided the interim employment did not last longer than one year. A director would not be considered independent while serving as an interim officer. Similarly, for purposes of paragraph (B) of the Rule, compensation received by a director for former service as an interim executive officer need not be considered as compensation in determining independence after such

service, provided such interim employment did not last longer than one year. Nonetheless, the issuer's board of directors still must consider whether such former employment and any compensation received would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director. In addition, if the director participated in the preparation of the company's financial statements while serving as an interim executive officer, Rule 4350(d)(2)(A)(iii) would preclude service on the audit committee for three years.

Paragraph (B) of the Rule is generally intended to capture situations where a compensation is made directly to (or for the benefit of) the director or a Family Member of the director. For example, consulting or personal service contracts with a director or Family Member of the director would be analyzed under paragraph (B) of the Rule. In addition, political contributions to the campaign of a director or a Family Member of the director would be considered indirect compensation under paragraph (B). Non-preferential payments made in the ordinary course of providing business services (such as payments of interest or proceeds related to banking services or loans by an issuer that is a financial institution or payment of claims on a policy by an issuer that is an insurance company), payments arising solely from investments in the company's securities and loans permitted under Section 13(k) of the Act will not preclude a finding of director independence as long as the payments are non-compensatory in nature. Depending on the circumstances, a loan or payment could be compensatory if, for example, it is not on terms generally available to the public.

Paragraph (D) of the Rule is generally intended to capture payments to an entity with which the director or Family Member of the director is affiliated by serving as a partner, controlling shareholder or executive officer of such entity. Under exceptional circumstances, such as where a director has direct, significant business holdings, it may be appropriate to apply the corporate measurements in paragraph (D), rather than the individual measurements of paragraph (B). Issuers should contact Nasdaq if they wish to apply the Rule in this manner. The reference to a partner in paragraph (D) is not intended to include limited partners. It should be noted that the independence requirements of paragraph (D) of the Rule are broader than SEC Rule 10A-3(e)(8) under the Act.

Under paragraph (D), a director who is, or who has a Family Member who is, an executive officer of a charitable organization may not be considered independent if the company makes payments to the charity in excess of the greater of 5% of the charity's revenues or \$200,000. However, Nasdaq encourages companies to consider other situations where a director or their Family Member and the company each have a relationship with the same charity when assessing director independence.

For purposes of determining whether a lawyer is eligible to serve on an audit committee, SEC Rule 10A-3 under the Act generally provides that any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee. In determining whether a director may be considered independent for purposes other than the audit committee, payments to a law firm would generally be considered under Rule 4200(a)(15)(D), which looks to whether the payment exceeds the greater of 5% of the recipient's gross revenues or \$200,000; however, if the firm is a sole proprietorship, Rule 4200(a)(15)(B), which looks to whether the payment exceeds \$100,000, applies.

Paragraph (G) of the Rule provides a different measurement for independence for investment companies in order to harmonize with the Investment Company Act of 1940. In particular, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee, shall not be considered independent.

[Adopted by SEC Release 34-53128 (Jan. 13, 2006). Amended by SR-NASDAQ-2006-021 eff. Oct. 6, 2006. Amended by SR-NASDAQ-2006-041 eff. Mar. 13, 2007.]

NASDAQ Rule 4350. Qualitative Listing Requirements for Nasdaq National Market and Nasdaq SmallCap Market Issuers Except for Limited Partnerships

(a) Applicability

(1) **Foreign Private Issuers.** A foreign private issuer may follow its home country practice in lieu of the requirements of Rule 4350, provided, however, that such an issuer shall: comply with Rules 4350(b)(1)(B), 4350(j) and 4350(m), have an audit committee that satisfies Rule 4350(d)(3), and ensure that such audit committee's members meet the independence requirement in Rule 4350(d)(2)(A)(ii). A foreign private issuer that follows a home country practice in lieu of one or more provisions of Rule 4350 shall disclose in its annual reports filed with the Commission or on its website each requirement of Rule 4350 that it does not follow and describe the home country practice followed by the issuer in lieu of such requirements. In addition, a foreign private issuer making its initial public offering or first U.S. listing on Nasdaq shall make the same disclosures in its registration statement or on its website.

(2) **Management Investment Companies.** Management investment companies (including business development companies) are subject to all the requirements of Rule 4350, except that management investment companies registered under the Investment Company Act of 1940 are exempt from the requirements of Rule 4350(c) and (n).

(3) **Asset-backed Issuers and Other Passive Issuers.** The following are exempt from the requirements of Rule 4350(c), (d) and (n): (a) asset-backed issuers; and (b) issuers, such as unit investment trusts, that are organized as trusts or other unincorporated associations that do not have a board of directors or persons acting in a similar capacity and whose activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

(4) **Cooperatives.** Cooperative entities, such as agricultural cooperatives, that are structured to comply with relevant state law and federal tax law and that do not have a publicly traded class of common stock are exempt from Rule 4350(c). However, such entities must comply with all federal securities laws, including without limitation those rules required by Section 10A(m) of the Act and Rule 10A-3 thereunder.

(5) **Phase-In Periods.** Compliance with the independent committee requirements set forth in Rule 4350(c) on the same schedule as it is permitted to phase in its compliance with the independent audit committee requirement pursuant to SEC Rule 10A-3(b)(1)(iv)(A). Accordingly, a company listing in connection with its initial public offering shall be permitted to phase in its compliance with the independent committee requirements set forth in Rule 4350(c) as follows: (1) one independent member at the time of listing; (2) a majority of independent members within 90 days of listing; and (3) all independent members within one year of listing. Furthermore, a company listing in connection with its initial public offering shall have twelve months from the date of listing to comply with the majority independent board requirement in Rule 4350(c). It should be noted, however, that pursuant to SEC Rule 10A-3(b)(1)(iii) investment companies are not afforded the exemptions under SEC Rule 10A-3(b)(1)(iv). Issuers may choose not to adopt a compensation or nomination committee and may instead rely upon a majority of the independent directors to discharge responsibilities under Rule 4350(c). For purposes of Rule 4350 other than Rule 4350(d)(2)(A)(ii) and Rule 4350(m), a company shall be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Act. For purposes of Rule 4350(d)(2)(A)(ii) and Rule 4350(m), a company shall be considered to be listing in conjunction with an initial public offering only if it meets the conditions in SEC Rule 10A-3(b)(1)(iv)(A) under the Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the Commission pursuant to Section 13(a) or 15(d) of the Act.

Companies that are emerging from bankruptcy or have ceased to be Controlled Companies within the meaning of Rule 4350(c)(5) shall be permitted to phase-in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with their initial public offering. It should be noted, however, that a company that has ceased to be a Controlled Company within the meaning of Rule 4350(c)(5) must comply with the audit committee requirements of Rule 4350(d) as of the date it ceased to be a Controlled

Company. Furthermore, the executive sessions requirement of Rule 4350(c)(2) applies to Controlled Companies as of the date of listing and continues to apply after it ceases to be controlled.

Companies transferring from other markets with a substantially similar requirement shall be afforded the balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement shall be afforded one year from the date of listing on Nasdaq. This transition period is not intended to supplant any applicable requirements of Rule 10A-3 under the Act.

(b) Distribution of Annual and Interim Reports

(1)(A) Each issuer shall make available to shareholders of such securities an annual report containing audited financial statements of the company and its subsidiaries, which, for example, may be on Form 10-K, 20-F, 40-F or N-CSR. An issuer may comply with this requirement either: (i) by mailing the report to shareholders, or (ii) by posting the annual report to shareholders on or through the company's website (or, in the case of an issuer that is an investment company that does not maintain its own website, on a website that the issuer is allowed to use to satisfy the website posting requirement in Exchange Act Rule 16a-3(k)), along with a prominent undertaking in the English language to provide shareholders, upon request, a hard copy of the company's annual report free of charge. An issuer that chooses to satisfy this requirement via a website posting must, simultaneous with this posting, issue a press release stating that its annual report has been filed with the Commission (or other appropriate regulatory authority). This press release must also state that the annual report is available on the company's website and include the website address and that shareholders may receive a hard copy free of charge upon request. An issuer must provide such hard copies within a reasonable period of time following the request.

(B) An issuer that receives an audit opinion that expresses doubt about the ability of the company to continue as a going concern for a reasonable period of time must make a public announcement through the news media disclosing the receipt of such opinion. Prior to the release of the public announcement, the issuer must provide the text of the public announcement to the StockWatch section of Nasdaq's MarketWatch Department ("Nasdaq StockWatch"). The public announcement shall be provided to Nasdaq StockWatch and released to the media not later than seven calendar days following the filing of such audit opinion in a public filing with the Securities and Exchange Commission.

(2) Each issuer which is subject to SEC Rule 13a-13 shall make available copies of quarterly reports including statements of operating results to shareholders either prior to or as soon as practicable following the company's filing of its Form 10-Q with the Commission. If the form of such quarterly report differs from the Form 10-Q, the issuer shall file one copy of the report with Nasdaq in addition to filing its Form 10-Q pursuant to Rule 4310(c)(14). The statement of operations contained in quarterly reports shall disclose, as a minimum, any substantial items of an unusual or nonrecurrent nature and net income before and after estimated federal income taxes or net income and the amount of estimated federal taxes.

(3) Each issuer which is not subject to SEC Rule 13a-13 and which is required to file with the Commission, or another federal or state regulatory authority, interim reports relating primarily to operations and financial position, shall make available to shareholders reports which reflect the information contained in those interim reports. Such reports shall be made available to shareholders either before or as soon as practicable following filing with the appropriate regulatory authority. If the form of the interim report provided to shareholders differs from that filed with the regulatory authority, the issuer shall file one copy of the report to shareholders with Nasdaq in addition to the report to the regulatory authority that is filed with Nasdaq pursuant to Rule 4310(c)(14).

(4) Each foreign private issuer shall publish, in a press release, which would also be submitted on a Form 6-K, an interim balance sheet and income statement as of the end of its second quarter. This information, which must be presented in English but does not have to be reconciled to U.S. GAAP, must be provided not later than six months following the end of the issuer's second quarter.

(c) Independent Directors

(1) A majority of the board of directors must be comprised of independent directors as defined in Rule 4200. The company must disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) those directors that the board of directors has determined to be independent under Rule 4200. If an issuer fails to comply with this requirement due to one vacancy, or one director ceases to be independent due to circumstances beyond their reasonable control, the issuer shall regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with this requirement, the issuer shall instead have 180 days from such event to regain compliance. An issuer relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

(2) Independent directors must have regularly scheduled meetings at which only independent directors are present ("executive sessions").

(3) Compensation of Officers

(A) Compensation of the chief executive officer of the company must be determined, or recommended to the Board for determination, either by:

- (i) a majority of the independent directors, or
- (ii) a compensation committee comprised solely of independent directors.

The Chief executive officer may not be present during voting or deliberations.

(B) Compensation of all other executive officers must be determined, or recommended to the Board for determination, either by:

- (i) a majority of the independent directors, or
- (ii) a compensation committee comprised solely of independent directors.

(C) Notwithstanding paragraphs (3)(A)(ii) and (3)(B)(ii) above, if the compensation committee is comprised of at least three members, one director who is not independent as defined in Rule 4200 and is not a current officer or employee or a Family Member of an officer or employee, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the proxy statement for the next annual meeting subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

(4) Nomination of Directors

(A) Director nominees must either be selected, or recommended for the Board's selection, either by:

- (i) a majority of the independent directors, or

(ii) a nominations committee comprised solely of independent directors.

(B) Each issuer must certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws.

(C) Notwithstanding paragraph (4)(A)(ii) above, if the nominations committee is comprised of at least three members, one director, who is not independent as defined in Rule 4200 and is not a current officer or employee or a Family Member of an officer or employee, may be appointed to the nominations committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the proxy statement for next annual meeting subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

(D) Independent director oversight of director nominations shall not apply in cases where the right to nominate a director legally belongs to a third party. However, this does not relieve a company's obligation to comply with the committee composition requirements under Rule 4350(c) and (d).

(E) This Rule 4350(c)(4) is not applicable to a company if the company is subject to a binding obligation that requires a director nomination structure inconsistent with this rule and such obligation pre-dates the approval date of this rule.

(5) A Controlled Company is exempt from the requirements of this Rule 4350(c), except for the requirements of subsection (c)(2) which pertain to executive sessions of independent directors. A Controlled Company is a company of which more than 50% of the voting power is held by an individual, a group or another company. A Controlled Company relying upon this exemption must disclose in its annual meeting proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) that it is a Controlled Company and the basis for that determination.

(d) Audit Committee

(1) Audit Committee Charter

Each Issuer must certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify:

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor; and

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer;

(D) the specific audit committee responsibilities and authority set forth in Rule 4350(d)(3).

(2) Audit Committee Composition

(A)(i) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three

members, each of whom must be independent as defined under Rule 4200(c)(15); (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c)); (iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and (iv) be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(B)(i) Notwithstanding paragraph (2)(A)(i), one director who is not independent as defined in Rule 4200; (ii) meets the criteria set forth in Section 10A(m)(3) under the Act and the rules thereunder; and (iii) is not a current officer or employee or a family member of such officer or employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the company and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for that determination. A member appointed under this exception may not serve longer than two years and may not chair the audit committee.

(3) Audit Committee Responsibilities and Authority

The audit committee must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c)), concerning responsibilities relating to: (i) registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing matters, (iii) authority to engage advisors, and (iv) funding as determined by the audit committee. Audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

(4) Cure Periods

(A) If an issuer fails to comply with the audit committee composition requirement under Rule 10A-3(b)(1) under the Act and Rule 4350(d)(2) because an audit committee member ceases to be independent for reasons outside the member's reasonable control, the audit committee member may remain on the audit committee until the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

(B) If an issuer fails to comply with the audit committee composition requirement under Rule 4350(d)(2)(A) due to one vacancy on the audit committee, and the cure period in paragraph (A) is not otherwise being relied upon for another member, the issuer will have until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the vacancy, the issuer shall instead have 180 days from such event to regain compliance. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

(5) Exception

At any time when an issuer has a class of common equity securities (or similar securities') that is listed on another

national securities exchange or national securities association subject to the requirements of SEC Rule 10A-3 under the Act, the listing of classes of securities of a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer (except classes of equity securities, other than non-convertible, non-participating preferred securities, of such subsidiary) shall not be subject to the requirements of this paragraph (d).

Cross Reference IM-4200, Definition of Independence - Rule 4200(a)(15)

Cross Reference IM-4350-4, Board Independence and Independent Committees

(e) Shareholder Meetings

Each issuer listing common stock or voting preferred stock, and their equivalents, shall hold an annual meeting of shareholders no later than one year after the end of the issuer's fiscal year-end.

(f) Quorum

Each issuer shall provide for a quorum as specified in its by-laws for any meeting of the holders of common stock; provided, however, that in no case shall such quorum be less than 33 1/3 % of the outstanding shares of the company's common voting stock.

(g) Solicitation of Proxies

Each issuer shall solicit proxies and provide proxy statements for all meetings of shareholders and shall provide copies of such proxy solicitation to Nasdaq.

(h) Conflicts of Interest

Each issuer shall conduct an appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis and all such transactions shall be approved by the company's audit committee or another independent body of the board of directors. For purposes of this rule, the term "related party transaction" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404. However, in the case of small business issuers (as that term is defined in SEC Rule 12b-2), the term "related party transactions" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-B, Item 404, and in the case of non-U.S. issuers, the term "related party transactions" shall refer to transactions required to be disclosed pursuant to Form 20-F, Item 7.B.

(i) Shareholder Approval

(1) Each issuer shall require shareholder approval prior to the issuance of designated securities under subparagraph (A), (B), (C), or (D) below:

(A) when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which options or stock may be acquired by officers, directors, employees, or consultants, except for:

(i) warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of the company (such as a typical dividend reinvestment plan); or

(ii) tax qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of *Section 401(a)* or *423 of the Internal Revenue Code*) or parallel nonqualified plans, provided such plans are approved by the issuer's independent compensation committee or a majority of the issuer's independent directors; or plans that merely provide a

convenient way to purchase shares on the open market or from the issuer at fair market value; or

(iii) plans or arrangements relating to an acquisition of merger as permitted under IM-4350-5; or

(iv) issuances to a person not previously an employee or director of the company, or following a bonafide period of non-employment, as an inducement material to the individual's entering into employment with the company, provided such issuances are approved by either the issuer's independent compensation committee or a majority of the issuer's independent directors. Promptly following an issuance of any employment inducement grant in reliance on this exception, a company must disclose in a press release the material terms of the grant, including the recipient(s) of the grant and the number of shares involved.

(B) when the issuance or potential issuance will result in a change of control of the issuer;

(C) in connection with the acquisition of the stock or assets of another company if:

(i) any director, officer or substantial shareholder of the issuer has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in an increase in outstanding common shares or voting power of 5% or more; or

(ii) where, due to the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, other than a public offering for cash:

a. the common stock has or will have upon issuance voting power equal to or in excess of 20% of the voting power outstanding before the issuance of stock or securities convertible into or exercisable for common stock; or

b. the number of shares of common stock to be issued is or will be equal to or in excess of 20% of the number of shares or common stock outstanding before the issuance of the stock or securities; or

(D) in connection with a transaction other than a public offering involving:

(i) the sale, issuance or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by officers, directors or substantial shareholders of the company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; or

(ii) the sale, issuance or potential issuance by the company of common stock (or securities convertible into or exercisable common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock.

(2) An exception applicable to a specified issuance of securities may be made upon prior written application to Nasdaq's Listing Qualifications Department when: (A) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise; and (B) reliance by the company on this exception is expressly approved by the audit committee or a comparable body of the board of directors comprised solely of independent, disinterested directors. The Listing Qualifications Department shall respond to each application for such an exception in writing.

A company that receives such an exception must mail to all shareholders not later than ten days before issuance of the securities a letter alerting them to its omission to seek the shareholder approval that would otherwise be required. Such notification shall disclose the terms of the transaction (including the number of shares of common stock that could be

issued and the consideration received), the fact that the issuer is relying on a financial viability exception to the shareholder approval rules, and that the audit committee or a comparable body of the board of directors comprised solely of independent, disinterested directors has expressly approved reliance on the exception. The issuer shall also make a public announcement through the news media disclosing the same information as promptly as possible, but no later than ten days before the issuance of the securities.

(3) Only shares actually issued and outstanding (excluding treasury shares or shares held by a subsidiary) are to be used in making any calculation provided for in this paragraph (i). Unissued shares reserved for issuance upon conversion of securities or upon exercise of options or warrants will not be regarded as outstanding.

(4) Voting power outstanding as used in this Rule refers to the aggregate number of votes which may be cast by holders of those securities outstanding which entitle the holders thereof to vote generally on all matters submitted to the company's security holders for a vote.

(5) An interest consisting of less than either 5% of the number of shares of common stock or 5% of the voting power outstanding of an issuer or party shall not be considered a substantial interest or cause the holder of such an interest to be regarded as a substantial security holder.

(6) Where shareholder approval is required, the minimum vote which will constitute shareholder approval shall be a majority of the total votes cast on the proposal. These votes may be cast in person, by proxy at a meeting of shareholders or by written consent in lieu of a special meeting to the extent permitted by applicable state and federal law and rules (including interpretations thereof), including, without limitation, SEC Regulations 14A and 14C. Nothing contained in this Rule 4350(i)(6) shall affect an issuer's obligation to hold an annual meeting of shareholders as required by Rule 4350(e).

(7) Shareholder approval shall not be required for any share issuance if such issuance is part of a court-approved reorganization under the federal bankruptcy laws or comparable foreign laws.

Cross Reference IM-4350-1, Future Priced Securities

Cross Reference IM-4350-2, Interpretative Material Regarding the use of Share Caps to Comply with Rule 4350(i)

Cross Reference IM-4350-3, Definition of Public Offering

Cross Reference IM-4350-5, Shareholder Approval for Stock Option Plans or Other Equity Compensation Arrangements

(j) Listing Agreement

Each issuer shall execute a Listing Agreement in the form designated by Nasdaq.

(k) Auditor Registration

Each Listed issuer must be audited by an independent public accountant that is registered as a public accounting firm with the Public Company Accounting Oversight Board, as provided for in Section 102 of the Sarbanes-Oxley Act of 2002 [15 U.S.C. 7212].

(l) Direct Registration Program

If an issuer establishes or maintains a Direct Registration Program for its shareholders, the issuer shall, directly or

through its transfer agent, participate in an electronic link with a securities depository registered under Section 17A of the Exchange Act to facilitate the electronic transfer of securities held pursuant to such program

(1) All securities initially listing on Nasdaq on or after January 1, 2007 must be eligible for a Direct Registration Program operated by a clearing agency registered under Section 17A of the Exchange Act. This provision does not extend to: (i) additional classes of securities of companies which already have securities listed on Nasdaq; (ii) companies which immediately prior to such listing had securities listed on another registered securities exchange in the U.S.; or, (iii) non-equity securities which are book-entry only.

(2) On and after March 31, 2008 all securities listed on Nasdaq (except non-equity securities which are book-entry only) must be eligible for a Direct Registration Program operated by a clearing agency registered under Section 17A of the Exchange Act.

(3) If an issuer establishes or maintains a Direct Registration Program for its shareholders, the issuer shall, directly or through its transfer agent, participate in an electronic link with a clearing agency registered under Section 17A of the Act to facilitate the electronic transfer of securities held pursuant to such program.

(m) Notification of Material Noncompliance

An issuer must provide Nasdaq with prompt notification after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with the requirements of this Rule 4350.

(n) Code of Conduct

Each Issuer shall adopt a code of conduct applicable to all directors, officers and employees, which shall be publicly available. A code of conduct satisfying this rule must comply with the definition of a "code of ethics" set out in Section 406(c) of the Sarbanes--Oxley Act of 2002 ("the Sarbanes-Oxley Act") and any regulations promulgated thereunder by the Commission. See *17 C.F.R. 228.406* and *17 C.F.R. 229.406*. In addition, the code must provide for an enforcement mechanism. Any waivers of the code for directors or executive officers must be approved by the Board. Issuers, other than **foreign private issuers**, shall disclose such waivers in a Form 8-K within four business days. **Foreign private issuers** shall disclose such waivers either in a Form 6-K or in the next Form 20-F or 40-F.

Cross Reference IM-4350-7 Code of Conduct

[Adopted by SEC Release 34-53128 (Jan. 13, 2006). Amended by SR-NASDAQ-2006-007 eff. May 8, 2006. Amended by SR-NASDAQ-2006-019 eff. July 28, 2006. Amended by SR-NASDAQ-2006-008 eff. Aug. 8, 2006. Amended by SR-NASDAQ-2006-033 eff. Aug. 25, 2006. Amended by SR-NASDAQ-2006-011 eff. Sept. 11, 2006. Amended by SR-NASDAQ-2006-021 eff. Oct. 6, 2006. Amended by SR-NASDAQ-2007-022 eff. May 29, 2007. Amended by SR-NASDAQ-2006-045 eff. Aug. 24, 2007. Amended by SR-NASDAQ-2007-101 eff. Dec. 28, 2007.]

Selected Notices to Members: 91-33.

IM-4350-4. Board Independence and Independent Committees

Independent Directors and Independent Committees--Rule 4350(c)

Majority Independent Board. Independent directors (as defined in Rule 4200(a)(15)) play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the companies they oversee and guard against conflicts of interest. Requiring that the board be comprised of a majority of independent directors empowers such directors to carry out more effectively these

responsibilities.

Executive Sessions of Independent Directors. Regularly scheduled executive sessions encourage and enhance communication among independent directors. It is contemplated that executive sessions will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.

Independent Director Oversight of Executive Compensation. Independent director oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value. The rule is intended to provide flexibility for an issuer to choose an appropriate board structure and to reduce resource burdens, while ensuring independent director control of compensation decisions.

Independent Director Oversight of Director Nominations. Independent director oversight of nominations enhances investor confidence in the selection of well-qualified director nominees, as well as independent nominees as required by the rules. This rule is also intended to provide flexibility for a company to choose an appropriate board structure and reduce resource burdens, while ensuring that independent directors approve all nominations.

This rule does not apply in cases where the right to nominate a director legally belongs to a third party. For example, investors may negotiate the right to nominate directors in connection with an investment in the company, holders of preferred stock may be permitted to nominate or appoint directors upon certain defaults, or the company may be a party to a shareholder's agreement that allocates the right to nominate some directors. Because the right to nominate directors in these cases does not reside with the company, independent director approval would not be required. This rule is not applicable if the company is subject to a binding obligation that requires a director nomination structure inconsistent with the rule and such obligation pre-dates the approval date of this rule.

Controlled Company Exemption. This exemption recognizes that majority shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights. In order for a group to exist for purposes of this rule, the shareholders must have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D). A Controlled Company not relying upon this exemption need not provide any special disclosures about its controlled status. It should be emphasized that this controlled company exemption does not extend to the audit committee requirements under Rule 4350(d) or the requirement for executive sessions of independent directors under Rule 4350(c)(2).

Audit Committees--Rule 4350(d)

Audit Committee Charter. Each issuer is required to adopt a formal written charter that specifies the scope of its responsibilities and the means by which it carries out those responsibilities; the outside auditor's accountability to the audit committee; and the audit committee's responsibility to ensure the independence of the outside auditor. Consistent with this, the charter must specify all audit committee responsibilities set forth in Rule 10A-3(b)(2), (3), (4) and (5) under the Act. Rule 10A-3(b)(3)(ii) requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. The rights and responsibilities as articulated in the audit committee charter empower the audit committee and enhance its effectiveness in carrying out its responsibilities.

Rule 4350(d)(3) imposes additional requirements for investment company audit committees that must also be set forth in audit committee charters for these issuers.

Audit Committee Composition. Audit committees are required to have a minimum of three members and be comprised only of independent directors. In addition to satisfying the independent director requirements under Rule 4200, audit committee members must meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c)): they must not accept any consulting, advisory, or other

compensatory fee from the company other than for board service, and they must not be an affiliated person of the company. It is recommended that an issuer disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) if any director is deemed independent but falls outside the safe harbor provisions of Rule 10A-3(e)(1)(ii) under the Act. A director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K or Item 401(e) of Regulation S-B is presumed to qualify as a financially sophisticated audit committee member under Rule 4350(d)(2)(A).

The Audit Committee Responsibilities and Authority. Audit committees must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c)), concerning responsibilities relating to registered public accounting firms; complaints relating to accounting; internal accounting controls or auditing matters; authority to engage advisors; and funding. Audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

Executive Officers. References to executive officers in Rule 4350 mean those officers covered in Rule 16a-1(f) under the Act.

[Adopted by SEC Release 34-53128 (Jan. 13, 2006).]

IM-4350-5. Shareholder Approval for Stock Option Plans or Other Equity Compensation Arrangements

Employee ownership of company stock can be an effective tool to align employee interests with those of other shareholders. Stock option plans or other equity compensation arrangements can also assist in the recruitment and retention of employees, which is especially critical to young, growing companies, or companies with insufficient cash resources to attract and retain highly qualified employees. However, these plans can potentially dilute shareholder interests. As such, Rule 4350(i)(1)(A) ensures that shareholders have a voice in these situations, given this potential for dilution.

Rule 4350(i)(1)(A) requires shareholder approval when a plan or other equity compensation arrangement is established or materially amended. For these purposes, a material amendment would include, but not be limited to, the following:

- (1) any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction);
- (2) any material increase in benefits to participants, including any material change to: (i) permit a repricing (or decrease in exercise price) of outstanding options, (ii) reduce the price at which shares or options to purchase shares may be offered, or (iii) extend the duration of a plan;
- (3) any material expansion of the class of participants eligible to participate in the plan; and
- (4) any expansion in the types of options or awards provided under the plan.

While general authority to amend a plan would not obviate the need for shareholder approval, if a plan permits a specific action without further shareholder approval, then no such approval would generally be required. However, if a plan contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula"), or for automatic grants pursuant to a dollar-based formula (such as annual grants based on a certain dollar value, or matching contributions based upon the amount of compensation the participant elects to defer), such plans cannot have a term in excess of ten years unless shareholder approval is obtained every ten years. However, plans that do not contain

a formula and do not impose a limit on the number of shares available for grant would require shareholder approval of each grant under the plan. A requirement that grants be made out of treasury shares or repurchased shares will not alleviate these additional shareholder approval requirements.

As a general matter, when preparing plans and presenting them for shareholder approval, issuers should strive to make plan terms easy to understand. In that regard, it is recommended that plans meant to permit repricing use explicit terminology to make this clear.

Rule 4350(i)(1)(A) provides an exception to the requirement for shareholder approval for warrants or rights offered generally to all shareholders. In addition, an exception is provided for tax qualified, non-discriminatory employee benefit plans as well as parallel nonqualified plans as these plans are regulated under the Internal Revenue Code and Treasury Department regulations. An equity compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable tax qualified, non-discriminatory employee benefit plan or parallel nonqualified plan that the issuer provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, are also exempt from shareholder approval under this section.

Further, there is an exception for inducement grants to new employees because in these cases a company has an arm's length relationship with the new employees. Inducement grants for these purposes include grants of options or stock to new employees in connection with a merger or acquisition. The rule requires that such issuances must be approved by the issuer's independent compensation committee or a majority of the issuer's independent directors. The rule further requires that promptly following an issuance of any employment inducement grant in reliance on this exception, a company must disclose in a press release the material terms of the grant, including the recipient(s) of the grant and the number of shares involved.

In addition, plans or arrangements involving a merger or acquisition do not require shareholder approval in two situations. First, shareholder approval will not be required to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, shares available under certain plans acquired in acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exception applies to situations where the party which is not a listed company following the transaction has shares available for grant under pre-existing plans that meet the requirements of this Rule 4350(i)(1)(A). These shares may be used for post-transaction grants of options and other equity awards by the listed company (after appropriate adjustment of the number of shares to reflect the transaction), either under the pre-existing plan or arrangement or another plan or arrangement, without further shareholder approval, provided: (1) the time during which those shares are available for grants is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction, and (2) such options and other awards are not granted to individuals who were employed by the granting company or its subsidiaries at the time the merger or acquisition was consummated. Nasdaq would view a plan or arrangement adopted in contemplation of the merger or acquisition transaction as not pre-existing for purposes of this exception. This exception is appropriate because it will not result in any increase in the aggregate potential dilution of the combined enterprise. In this regard, any additional shares available for issuance under a plan or arrangement acquired in a connection with a merger or acquisition would be counted by Nasdaq in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock, thus triggering the shareholder approval requirements under Rule 4350(i)(1)(C).

Inducement grants, tax qualified non-discriminatory benefit plans, and parallel nonqualified plans are subject to approval by either the issuer's independent compensation committee or a majority of the issuer's independent directors. It should also be noted that a company would not be permitted to use repurchased shares to fund option plans or grants without prior shareholder approval.

For purposes of Rule 4350(i)(1)(A) and IM-4350-5, the term "parallel nonqualified plan" means a plan that is a "pension plan" within the meaning of the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. § 1002

(1999), that is designed to work in parallel with a plan intended to be qualified under *Internal Revenue Code Section 401(a)*, to provide benefits that exceed the limits set forth in *Internal Revenue Code Section 402(g)* (the section that limits an employee's annual pre-tax contributions to a 401(k) plan), *Internal Revenue Code Section 401(a)(17)* (the section that limits the amount of an employee's compensation that can be taken into account for plan purposes) and/or *Internal Revenue Code Section 415* (the section that limits the contributions and benefits under qualified plans) and/or any successor or similar limitations that may thereafter be enacted. However, a plan will not be considered a parallel nonqualified plan unless: (i) it covers all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit of Code Section 401(a)(17) (or any successor or similar limitation that may hereafter be enacted); (ii) its terms are substantially the same as the qualified plan that it parallels except for the elimination of the limitations described in the preceding sentence; and, (iii) no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation.

[Adopted by SEC Release 34-53128 (Jan. 13, 2006).]

IM-4350-7. Code of Conduct

Ethical behavior is required and expected of every corporate director, officer and employee whether or not a formal code of conduct exists. The requirement of a publicly available code of conduct applicable to all directors, officers and employees of an issuer is intended to demonstrate to investors that the board and management of Nasdaq issuers have carefully considered the requirement of ethical dealing and have put in place a system to ensure that they become aware of and take prompt action against any questionable behavior. For company personnel, a code of conduct with enforcement provisions provides assurance that reporting of questionable behavior is protected and encouraged, and fosters an atmosphere of self-awareness and prudent conduct.

Rule 4350(n) requires issuers to adopt a **code of conduct** complying with the definition of a "code of ethics" under Section 406(c) of the Sarbanes-Oxley Act of 2002 ("the Sarbanes-Oxley Act") and any regulations promulgated thereunder by the Commission. See *17 C.F.R. 228.406* and *17 C.F.R. 229.406*. Thus, the code must include such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure, and compliance with laws, rules and regulations, as specified by the Sarbanes-Oxley Act. However, the **code of conduct** required by Rule 4350(n) must apply to all directors, officers, and employees. Issuers can satisfy this obligation by adopting one or more **codes of conduct**, such that all directors, officers and employees are subject to a code that satisfies the definition of a "code of ethics."

As the Sarbanes-Oxley Act recognizes, investors are harmed when the real or perceived private interest of a director, officer or employee is in conflict with the interests of the company, as when the individual receives improper personal benefits as a result of his or her position with the company, or when the individual has other duties, responsibilities or obligations that run counter to his or her duty to the company. Also, the disclosures an issuer makes to the Commission are the essential source of information about the company for regulators and investors--there can be no question about the duty to make them fairly, accurately and timely. Finally, illegal action must be dealt with swiftly and the violators reported to the appropriate authorities. Each **code of conduct** must require that any waiver of the code for executive officers or directors may be made only by the board and must be disclosed to shareholders, along with the reasons for the waiver. All issuers, other than foreign private issuers, must disclose such waivers in a Form 8-K within four business days. Foreign private issuers must disclose such waivers either in a Form 6-K or in the next Form 20-F or 40-F. This disclosure requirement provides investors the comfort that waivers are not granted so as to protect the company and its shareholders to the greatest extent possible.

Each **code of conduct** must also contain an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations.

[Adopted by SEC Release 34-53128 (Jan. 13, 2006).]

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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES

2-D Corporate Governance: Law and Practice Appendix D.syn

**§ D.syn Synopsis to Appendix D: FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO
PUBLIC COMPANY OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES**

Sarbanes-Oxley § 201 Services Outside the Scope of Practice of Auditors [adding Section 10A(g) and (h) to the Exchange Act]

17 CFR § 210.2-01 Qualifications of accountants.

17 CFR § 210.2-07 Communication with audit committees.

17 CFR § 240.10A-2 Auditor independence.

17 CFR § 240.10A-3 Listing standards relating to audit committees.

Sarbanes-Oxley § 202 Preapproval Requirements [for auditing and non-auditing services adding Section 10A(I) to the Exchange Act]

Sarbanes-Oxley § 204 Auditor Reports to Audit Committees [adding Section 10A(k) to the Exchange Act]

Sarbanes-Oxley § 301 Public Company Audit Committees [adding Section 10A(m) to the Exchange Act]

Sarbanes-Oxley § 303 Improper Influence on Conduct of Audits

17 CFR § 240.13b2-2 Representations and conduct in connection with the preparation of required reports and documents.

Sarbanes-Oxley § 407 Disclosure of Audit Committee Financial Expert

17 CFR § 229.407(d)(5) Instructions [Implementing Sarbanes-Oxley § 407 Concerning Disclosures on Audit Committee Financial Experts]

17 CFR § 240.14a-101 Schedule 14A. Information required in proxy statement.



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
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2-D Corporate Governance: Law and Practice Sarbanes-Oxley § 201

§ Oxley201 Services Outside the Scope of Practice of Auditors [adding Section 10A(g) and (h) to the Exchange Act]

(a) Prohibited Activities.-- Section 10A of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1*) is amended by adding at the end the following:

(g) Prohibited Activities.--Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the 'Board'), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including--

- (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
- (2) financial information systems design and implementation;
- (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (4) actuarial services;
- (5) internal audit outsourcing services;
- (6) management functions or human resources;
- (7) broker or dealer, investment adviser, or investment banking services;
- (8) legal services and expert services unrelated to the audit; and
- (9) any other service that the Board determines, by regulation, is impermissible.

(h) Preapproval Required for Non-Audit Services.--A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for

an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).

(b) (15 USC 7231) *Exemption Authority*.-- The Board may, on a case by case basis, exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of services under section 10A(g) of the Securities Exchange Act of 1934 (as added by this section), to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors, and subject to review by the Commission in the same manner as for rules of the Board under section 107.



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
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2-D Corporate Governance: Law and Practice 17 CFR § 210.2-01

§ 01 Qualifications of accountants.

Preliminary Note to § 210.2-01

1. Section 210.2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.

2. Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in § 210.2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.

3. These factors are general guidance only and their application may depend on particular facts and circumstances. For that reason, § 210.2-01 provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the rule.

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in

good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

(c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section.

(1) Financial relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as:

(i) Investments in audit clients. An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities. The term direct investment includes an investment in an audit client through an intermediary if:

(1) The accounting firm, covered person, or immediate family member, alone or together with other persons, supervises or participates in the intermediary's investment decisions or has control over the intermediary; or

(2) The intermediary is not a diversified management investment company, as defined by section 5(b)(1) of the Investment Company Act of 1940, *15 U.S.C. 80a-5(b)(1)*, and has an investment in the audit client that amounts to 20% or more of the value of the intermediary's total investments.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G (*17 CFR 240.13d-101* or *240.13d-102*) with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities or controls an audit client, or a close

family member of a partner, principal, or shareholder of the accounting firm controls an audit client.

(C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust, or executor of an estate, containing the securities of an audit client, unless the accounting firm, covered person in the firm, or immediate family member has no authority to make investment decisions for the trust or estate.

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client. For purposes of this paragraph, the term material indirect investment does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons of 5% or less of the outstanding shares of a diversified management investment company, as defined by section 5(b)(1) of the Investment Company Act of 1940, *15 U.S.C. 80a-5(b)(1)*, that invests in an audit client.

(E) The accounting firm, any covered person in the firm, or any of his or her immediate family members:

(1) Has any direct or material indirect investment in an entity where:

(i) An audit client has an investment in that entity that is material to the audit client and has the ability to exercise significant influence over that entity; or

(ii) The entity has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client;

(2) Has any material investment in an entity over which an audit client has the ability to exercise significant influence; or

(3) Has the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.

(ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) Loans/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(1) Automobile loans and leases collateralized by the automobile;

(2) Loans fully collateralized by the cash surrender value of an insurance policy;

(3) Loans fully collateralized by cash deposits at the same financial institution; and

(4) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(B) Savings and checking accounts. Any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting firm account may have an uninsured balance provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote.

(C) Broker-dealer accounts. Brokerage or similar accounts maintained with a broker-dealer that is an audit client, if:

(1) Any such account includes any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act of 1970 ("SIPA") (*15 U.S.C. 78aaa et seq.*));

(2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of SIPA (*15 U.S.C. 78fff-3*); or

(3) With respect to non-U.S. accounts not subject to SIPA protection, the value of assets in the accounts exceeds the amount insured or protected by a program similar to SIPA.

(D) Futures commission merchant accounts. Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client.

(E) Credit cards. Any aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to \$10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

(F) Insurance products. Any individual policy issued by an insurer that is an audit client unless:

(1) The policy was obtained at a time when the covered person in the firm was not a covered person in the firm; and

(2) The likelihood of the insurer becoming insolvent is remote.

(G) Investment companies. Any financial interest in an entity that is part of an investment company complex that includes an audit client.

(iii) Exceptions. Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, an accountant will not be deemed not independent if:

(A) Inheritance and gift. Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance, that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

(B) New audit engagement. Any person has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and:

(1) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and

(2) The accountant is independent under paragraph (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:

(i) Signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client; or

(ii) Commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).

(C) Employee compensation and benefit plans. An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs (f)(11)(iii) or (f)(11)(iv) of this section has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the acquisition of the financial interest was an unavoidable consequence of participation in his or her employer's employee compensation or benefits program, provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than 30 days after the person has the right to dispose of the financial interest.

(iv) Audit clients' financial relationships. An accountant is not independent when:

(A) Investments by the audit client in the accounting firm. An audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options, or other securities, or the audit client's officers or directors are record or beneficial owners of more than 5% of the equity securities of the accounting firm.

(B) Underwriting. An accounting firm engages an audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst with respect to securities issued by the accounting firm.

(2) Employment relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:

(i) Employment at audit client of accountant. A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or serves as a member of the board of directors or similar management or governing body of the audit client.

(ii) Employment at audit client of certain relatives of accountant. A close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(iii) Employment at audit client of former employee of accounting firm.

(A) A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

(1) Does not influence the accounting firm's operations or financial policies;

(2) Has no capital balances in the accounting firm; and

(3) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):

(i) Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or

(ii) In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm for more than five years, that is immaterial to the former professional employee; and

(B) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role at an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(f)*)), except an issuer that is an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), unless the individual:

(1) Employed by the issuer was not a member of the audit engagement team of the issuer during the one year period preceding the date that audit procedures commenced for the fiscal period that included the date of initial employment of the audit engagement team member by the issuer;

(2) For purposes of paragraph (c)(2)(iii)(B)(1) of this section, the following individuals are not considered to be members of the audit engagement team:

(i) Persons, other than the lead partner and the concurring partner, who provided ten or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(B)(1) of this section;

(ii) Individuals employed by the issuer as a result of a business combination between an issuer that is an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware of the prior employment relationship; and

(iii) Individuals that are employed by the issuer due to an emergency or other unusual situation provided that the audit committee determines that the relationship is in the interest of investors;

(3) For purposes of paragraph (c)(2)(iii)(B)(1) of this section, audit procedures are deemed to have commenced for a fiscal period the day following the filing of the issuer's periodic annual report with the Commission covering the previous fiscal period; or

(C) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role with respect to an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), if:

(1) The former partner, principal, shareholder, or professional employee of an accounting firm is employed in a financial reporting oversight role related to the operations and financial reporting of the registered investment company at an entity in the investment company complex, as defined in (f)(14) of this section, that includes the registered investment company; and

(2) The former partner, principal, shareholder, or professional employee of an accounting firm employed by the registered investment company or any entity in the investment company complex was a member of the audit engagement team of the registered investment company or any other registered investment company in the investment company complex during the one year period preceding the date that audit procedures commenced that included the date of initial employment of the audit engagement team member by the registered investment company or any entity in the investment company complex.

(3) For purposes of paragraph (c)(2)(iii)(C)(2) of this section, the following individuals are not considered to be members of the audit engagement team:

(i) Persons, other than the lead partner and concurring partner, who provided ten or fewer hours of audit, review or attest

services during the period covered by paragraph (c)(2)(iii)(C)(2) of this section;

(ii) Individuals employed by the registered investment company or any entity in the investment company complex as a result of a business combination between a registered investment company or any entity in the investment company complex that is an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the registered investment company is aware of the prior employment relationship; and

(iii) Individuals that are employed by the registered investment company or any entity in the investment company complex due to an emergency or other unusual situation provided that the audit committee determines that the relationship is in the interest of investors.

(4) For purposes of paragraph (c)(2)(iii)(C)(2) of this section, audit procedures are deemed to have commenced the day following the filing of the registered investment company's periodic annual report with the Commission.

(iv) Employment at accounting firm of former employee of audit client. A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client.

(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

(4) Non-audit services. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

(i) Bookkeeping or other services related to the accounting records or financial statements of the audit client. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:

(A) Maintaining or preparing the audit client's accounting records;

(B) Preparing the audit client's financial statements that are filed with the Commission or that form the basis of financial statements filed with the Commission; or

(C) Preparing or originating source data underlying the audit client's financial statements.

(ii) Financial information systems design and implementation. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:

(A) Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network; or

(B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole.

(iii) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. Any appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(iv) Actuarial services. Any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(v) Internal audit outsourcing services. Any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements, for an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(vi) Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit

client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

(vii) Human resources.

(A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;

(B) Engaging in psychological testing, or other formal testing or evaluation programs;

(C) Undertaking reference checks of prospective candidates for an executive or director position;

(D) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

(E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

(viii) Broker-dealer, investment adviser, or investment banking services. Acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

(ix) Legal services. Providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

(x) Expert services unrelated to the audit. Providing an expert opinion or other expert service for an audit client, or an audit client's legal representative, for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. In any litigation or regulatory or administrative proceeding or investigation, an accountant's independence shall not be deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.

(5) Contingent fees. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

(6) Partner rotation.

(i) Except as provided in paragraph (c)(6)(ii) of this section, an accountant is not independent of an audit client when:

(A) Any audit partner as defined in paragraph (f)(7)(ii) of this section performs:

(1) The services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or concurring partner, as defined in paragraph (f)(7)(ii)(B) of this section, for more than five consecutive years; or

(2) One or more of the services defined in paragraphs (f)(7)(ii)(C) and (D) of this section for more than seven consecutive years;

(B) Any audit partner:

(1) Within the five consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(1) of this section, performs for that audit client the services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or concurring partner, as defined in paragraph (f)(7)(ii)(B) of this section, or a combination of those services, or

(2) Within the two consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(i)(A)(2) of this section, performs one or more of the services defined in paragraph (f)(7)(ii) of this section.

(ii) Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(f)*)) and less than ten partners shall be exempt from paragraph (c)(6)(i) of this section provided the Public Company Accounting Oversight Board conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under this

paragraph.

(iii) For purposes of paragraph (c)(6)(i) of this section, an audit client that is an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), does not include an affiliate of the audit client that is an entity in the same investment company complex, as defined in paragraph (f)(14) of this section, except for another registered investment company in the same investment company complex. For purposes of calculating consecutive years of service under paragraph (c)(6)(i) of this section with respect to investment companies in an investment company complex, audits of registered investment companies with different fiscal year-ends that are performed in a continuous 12-month period count as a single consecutive year.

(7) Audit committee administration of the engagement. An accountant is not independent of an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(f)*)), other than an issuer that is an Asset-Backed Issuer as defined in § 229.1101 of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (*15 U.S.C. 80a-4(2)*), unless:

(i) In accordance with Section 10A(i) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(i)*) either:

(A) Before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render audit or non-audit services, the engagement is approved by the issuer's or registered investment company's audit committee; or

(B) The engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committees responsibilities under the Securities Exchange Act of 1934 to management; or

(C) With respect to the provision of services other than audit, review or attest services the pre-approval requirement is waived if:

(1) The aggregate amount of all such services provided constitutes no more than five percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided;

(2) Such services were not recognized by the issuer or registered investment company at the time of the engagement to

be non-audit services; and

(3) Such services are promptly brought to the attention of the audit committee of the issuer or registered investment company and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

(ii) A registered investment company's audit committee also must pre-approve its accountant's engagements for non-audit services with the registered investment company's investment adviser (not including a sub-adviser whose role is primarily portfolio management and is sub-contracted or overseen by another investment adviser) and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company in accordance with paragraph (c)(7)(i) of this section, if the engagement relates directly to the operations and financial reporting of the registered investment company, except that with respect to the waiver of the pre-approval requirement under paragraph (c)(7)(i)(C) of this section, the aggregate amount of all services provided constitutes no more than five percent of the total amount of revenues paid to the registered investment company's accountant by the registered investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company during the fiscal year in which the services are provided that would have to be pre-approved by the registered investment company's audit committee pursuant to this section.

(8) Compensation. An accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review or attest services. Any accounting firm with fewer than ten partners and fewer than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(f)*)) shall be exempt from the requirement stated in the previous sentence.

(d) Quality controls. An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

(1) The covered person did not know of the circumstances giving rise to the lack of independence;

(2) The covered person's lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and

(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack

independence, and that covers at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside of the United States.

(4) For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934 (*15 U.S.C. 78l*), a quality control system will not provide such reasonable assurance unless it has at least the following features:

- (i) Written independence policies and procedures;
- (ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant's independence;
- (iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;
- (iv) An annual or on-going firm-wide training program about auditor independence;
- (v) An annual internal inspection and testing program to monitor adherence to independence requirements;
- (vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;
- (vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and
- (viii) A disciplinary mechanism to ensure compliance with this section.

(e)

(1) Transition and grandfathering. Provided the following relationships did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, the existence of the relationship on May 6, 2003 will not be deemed to impair an accountant's independence:

(i) Employment relationships that commenced at the issuer prior to May 6, 2003 as described in paragraph (c)(2)(iii)(B) of this section.

(ii) Compensation earned or received, as described in paragraph (c)(8) of this section during the fiscal year of the accounting firm that includes the effective date of this section.

(iii) Until May 6, 2004, the provision of services described in paragraph (c)(4) of this section provided those services are pursuant to contracts in existence on May 6, 2003.

(iv) The provision of services by the accountant under contracts in existence on May 6, 2003 that have not been pre-approved by the audit committee as described in paragraph (c)(7) of this section.

(v) Until the first day of the issuer's fiscal year beginning after May 6, 2003 by a "lead" partner and other audit partner (other than the "concurring" partner) providing services in excess of those permitted under paragraph (c)(6) of this section. An accountant's independence will not be deemed to be impaired until the first day of the issuer's fiscal year beginning after May 6, 2004 by a "concurring" partner providing services in excess of those permitted under paragraph (c)(6) of this section. For the purposes of calculating periods of service under paragraph (c)(6) of this section:

(A) For the "lead" and "concurring" partner, the period of service includes time served as the "lead" or "concurring" partner prior to May 6, 2003; and

(B) For audit partners other than the "lead" partner or "concurring" partner, and for audit partners in foreign firms, the period of service does not include time served on the audit engagement team prior to the first day of issuer's fiscal year beginning on or after May 6, 2003.

(2) Settling financial arrangements with former professionals. To the extent not required by pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, the requirement in paragraph (c)(2)(iii) of this section to settle financial arrangements with former professionals applies to situations that arise after the effective date of this section.

(f) Definitions of terms. For purposes of this section:

(1) Accountant, as used in paragraphs (b) through (e) of this section, means a registered public accounting firm, certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

(2) Accounting firm means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization's pension, retirement, investment, or similar plans.

(3)

(i) Accounting role means a role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them.

(ii) Financial reporting oversight role means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

(4) Affiliate of the audit client means:

(i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iii) An entity that has significant influence over the audit client, unless the audit client is not material to the

entity; and

(iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(5) Audit and professional engagement period includes both:

(i) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(ii) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period"):

(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client.

(iii) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(6) Audit client means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of this section.

(7)

(i) Audit engagement team means all partners, principals, shareholders and professional employees participating in an audit, review, or attestation engagement of an audit client, including audit partners and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding

technical or industry-specific issues, transactions, or events.

(ii) Audit partner means a partner or persons in an equivalent position, other than a partner who consults with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee and includes the following:

(A) The lead or coordinating audit partner having primary responsibility for the audit or review (the "lead partner");

(B) The partner performing a second level of review to provide additional assurance that the financial statements subject to the audit or review are in conformity with generally accepted accounting principles and the audit or review and any associated report are in accordance with generally accepted auditing standards and rules promulgated by the Commission or the Public Company Accounting Oversight Board (the "concurring or reviewing partner");

(C) Other audit engagement team partners who provide more than ten hours of audit, review, or attest services in connection with the annual or interim consolidated financial statements of the issuer or an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*); and

(D) Other audit engagement team partners who serve as the "lead partner" in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenues of the issuer's respective consolidated assets or revenues.

(8) Chain of command means all persons who:

(i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive;

(ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or

(iii) Provide quality control or other oversight of the audit.

(9) Close family members means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(10) Contingent fee means, except as stated in the next sentence, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. Solely for the purposes of this section, a fee is not a "contingent fee" if it is fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered.

(11) Covered persons in the firm means the following partners, principals, shareholders, and employees of an accounting firm:

(i) The "audit engagement team";

(ii) The "chain of command";

(iii) Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and

(iv) Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

(12) Group means two or more persons who act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant.

(13) Immediate family members means a person's spouse, spousal equivalent, and dependents.

(14) Investment company complex.

(i) "Investment company complex" includes:

(A) An investment company and its investment adviser or sponsor;

(B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity:

(1) Is an investment adviser or sponsor; or

(2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(C) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (*15 U.S.C. 80a-3(c)*) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section.

(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

(15) Office means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines.

(16) Rabbi trust means an irrevocable trust whose assets are not accessible to the accounting firm until all benefit obligations have been met, but are subject to the claims of creditors in bankruptcy or insolvency.

(17) Audit committee means a committee (or equivalent body) as defined in section 3(a)(58) of the Securities Exchange Act of 1934 (*15 U.S.C. 78c(a)(58)*).

Legislative History

HISTORY: [37 FR 14594, July 21, 1972, as amended at 48 FR 9521, March 7, 1983; 65 FR 76082, Dec. 5, 2000; 68 FR 6044, Feb. 5, 2003; 70 FR 1593, Jan. 7, 2005.]

AUTHORITY: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

NOTES: [EFFECTIVE DATE NOTE: 70 FR 1506, 1593, Jan. 7, 2005, amended paragraph (c)(7), effective Mar. 8, 2005. For compliance date information, *see* 70 FR 1506, Jan. 7, 2005.]



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES

2-D Corporate Governance: Law and Practice 17 CFR § 210.2-07

§ 07 Communication with audit committees.

(a) Each registered public accounting firm that performs for an audit client that is an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(f)*)), other than an issuer that is an Asset-Backed Issuer as defined in § 229.1101 of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (*15 U.S.C. 80a-4(2)*), any audit required under the securities laws shall report, prior to the filing of such audit report with the Commission (or in the case of a registered investment company, annually, and if the annual communication is not within 90 days prior to the filing, provide an update, in the 90 day period prior to the filing, of any changes to the previously reported information), to the audit committee of the issuer or registered investment company:

(1) All critical accounting policies and practices to be used;

(2) All alternative treatments within Generally Accepted Accounting Principles for policies and practices related to material items that have been discussed with management of the issuer or registered investment company, including:

(i) Ramifications of the use of such alternative disclosures and treatments; and

(ii) The treatment preferred by the registered public accounting firm;

(3) Other material written communications between the registered public accounting firm and the management of the issuer or registered investment company, such as any management letter or schedule of unadjusted differences;

(4) If the audit client is an investment company, all non-audit services provided to any entity in an investment company complex, as defined in § 210.2-01 (f)(14), that were not pre-approved by the registered investment company's audit committee pursuant to § 210.2-01 (c)(7).

(b) [Reserved.]

Legislative History

HISTORY: [68 FR 6048, Feb. 5, 2003; 70 FR 1593, Jan. 7, 2005.]

AUTHORITY: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

NOTES: [EFFECTIVE DATE NOTE: 70 FR 1506, 1593, Jan. 7, 2005, amended paragraph (a), effective Mar. 8, 2005. For compliance date information, see 70 FR 1506, Jan. 7, 2005.]



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES

2-D Corporate Governance: Law and Practice 17 CFR § 240.10A-2

§ 2 Auditor independence.

It shall be unlawful for an auditor not to be independent under § 210.2- 01(c)(2)(iii)(B), (c)(4), (c)(6), (c)(7), and § 210.2-07.

Legislative History

HISTORY: [68 FR 6048, Feb. 5, 2003.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 781, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c; Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1). Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a).

Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 781, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 781, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 781, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 68 FR 6006, 6048, Feb. 5, 2003, added this section, effective May 6, 2003.]



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Corporate Governance: Law and Practice

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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES

2-D Corporate Governance: Law and Practice 17 CFR § 240.10A-3

§ 3 Listing standards relating to audit committees.

(a) Pursuant to section 10A(m) of the Act (*15 U.S.C. 78j-1(m)*) and section 3 of the Sarbanes-Oxley Act of 2002 (*15 U.S.C. 7202*):

(1) National securities exchanges. The rules of each national securities exchange registered pursuant to section 6 of the Act (*15 U.S.C. 78f*) must, in accordance with the provisions of this section, prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(2) National securities associations. The rules of each national securities association registered pursuant to section 15A of the Act (*15 U.S.C. 78o-3*) must, in accordance with the provisions of this section, prohibit the initial or continued listing in an automated inter-dealer quotation system of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(3) Opportunity to cure defects. The rules required by paragraphs (a)(1) and (a)(2) of this section must provide for appropriate procedures for a listed issuer to have an opportunity to cure any defects that would be the basis for a prohibition under paragraph (a) of this section, before the imposition of such prohibition. Such rules also may provide that if a member of an audit committee ceases to be independent in accordance with the requirements of this section for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain an audit committee member of the listed issuer until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

(4) Notification of noncompliance. The rules required by paragraphs (a)(1) and (a)(2) of this section must include a requirement that a listed issuer must notify the applicable national securities exchange or national securities association promptly after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the requirements of this section.

(5) Implementation.

(i) The rules of each national securities exchange or national securities association meeting the requirements of this section must be operative, and listed issuers must be in compliance with those rules, by the following dates:

(A) July 31, 2005 for foreign private issuers and smaller reporting companies (as defined in § 240.12b-2); and

(B) For all other listed issuers, the earlier of the listed issuer's first annual shareholders meeting after January 15, 2004, or October 31, 2004.

(ii) Each national securities exchange and national securities association must provide to the Commission, no later than July 15, 2003, proposed rules or rule amendments that comply with this section.

(iii) Each national securities exchange and national securities association must have final rules or rule amendments that comply with this section approved by the Commission no later than December 1, 2003.

(b) Required standards--

(1) Independence.

(i) Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent; provided that, where a listed issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of such dual holding companies.

(ii) Independence requirements for non-investment company issuers. In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

(B) Be an affiliated person of the issuer or any subsidiary thereof.

(iii) Independence requirements for investment company issuers. In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

(B) Be an "interested person" of the issuer as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*).

(iv) Exemptions from the independence requirements.

(A) For an issuer listing securities pursuant to a registration statement under section 12 of the Act (*15 U.S.C. 78l*), or for an issuer that has a registration statement under the Securities Act of 1933 (*15 U.S.C. 77a et seq.*) covering an initial public offering of securities to be listed by the issuer, where in each case the listed issuer was not, immediately prior to the effective date of such registration statement, required to file reports with the Commission pursuant to section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*):

(1) All but one of the members of the listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for 90 days from the date of effectiveness of such registration statement; and

(2) A minority of the members of the listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for one year from the date of effectiveness of such registration statement.

(B) An audit committee member that sits on the board of directors of a listed issuer and an affiliate of the listed issuer is exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if the member, except for being a director on each such board of directors, otherwise meets the independence requirements of paragraph (b)(1)(ii) of this section for each such entity, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of each such entity.

(C) An employee of a foreign private issuer who is not an executive officer of the foreign private issuer is exempt from the requirements of paragraph (b)(1)(ii) of this section if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.

(D) An audit committee member of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(1) The member is an affiliate of the foreign private issuer or a representative of such an affiliate;

(2) The member has only observer status on, and is not a voting member or the chair of, the audit committee;
and

(3) Neither the member nor the affiliate is an executive officer of the foreign private issuer.

(E) An audit committee member of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(1) The member is a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer; and

(2) The member is not an executive officer of the foreign private issuer.

(F) In addition to paragraphs (b)(1)(iv)(A) through (E) of this section, the Commission may exempt from the requirements of paragraphs (b)(1)(ii) or (b)(1)(iii) of this section a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

(2) Responsibilities relating to registered public accounting firms. The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

(3) Complaints. Each audit committee must establish procedures for:

(i) The receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and

(ii) The confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.

(4) Authority to engage advisers. Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

(5) Funding. Each listed issuer must provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of:

(i) Compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer;

(ii) Compensation to any advisers employed by the audit committee under paragraph (b)(4) of this section; and

(iii) Ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

(c) General exemptions.

(1) At any time when an issuer has a class of securities that is listed on a national securities exchange or national securities association subject to the requirements of this section, the listing of other classes of securities of the listed issuer on a national securities exchange or national securities association is not subject to the requirements of this section.

(2) At any time when an issuer has a class of common equity securities (or similar securities) that is listed on a national securities exchange or national securities association subject to the requirements of this section, the listing of classes of securities of a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer (except classes of equity securities, other than non-convertible, non-participating preferred securities, of such subsidiary) is not subject to the requirements of this section.

(3) The listing of securities of a foreign private issuer is not subject to the requirements of paragraphs (b)(1) through (b)(5) of this section if the foreign private issuer meets the following requirements:

(i) The foreign private issuer has a board of auditors (or similar body), or has statutory auditors, established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body;

(ii) The board or body, or statutory auditors is required under home country legal or listing requirements to be either:

(A) Separate from the board of directors; or

(B) Composed of one or more members of the board of directors and one or more members that are not also members of the board of directors;

(iii) The board or body, or statutory auditors, are not elected by management of such issuer and no executive

officer of the foreign private issuer is a member of such board or body, or statutory auditors;

(iv) Home country legal or listing provisions set forth or provide for standards for the independence of such board or body, or statutory auditors, from the foreign private issuer or the management of such issuer;

(v) Such board or body, or statutory auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, are responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and

(vi) The audit committee requirements of paragraphs (b)(3), (b)(4) and (b)(5) of this section apply to such board or body, or statutory auditors, to the extent permitted by law.

(4) The listing of a security futures product cleared by a clearing agency that is registered pursuant to section 17A of the Act (*15 U.S.C. 78q-1*) or that is exempt from the registration requirements of section 17A pursuant to paragraph (b)(7)(A) of such section is not subject to the requirements of this section.

(5) The listing of a standardized option, as defined in § 240.9b-1(a)(4), issued by a clearing agency that is registered pursuant to section 17A of the Act (*15 U.S.C. 78q-1*) is not subject to the requirements of this section.

(6) The listing of securities of the following listed issuers are not subject to the requirements of this section:

(i) Asset-Backed Issuers (as defined in § 229.1101 of this chapter);

(ii) Unit investment trusts (as defined in *15 U.S.C. 80a-4(2)*); and

(iii) Foreign governments (as defined in § 240.3b-4(a)).

(7) The listing of securities of a listed issuer is not subject to the requirements of this section if:

(i) The listed issuer, as reflected in the applicable listing application, is organized as a trust or other unincorporated association that does not have a board of directors or persons acting in a similar capacity; and

(ii) The activities of the listed issuer that is described in paragraph (c)(7)(i) of this section are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

(d) Disclosure. Any listed issuer availing itself of an exemption from the independence standards contained in paragraph (b)(1)(iv) of this section (except paragraph (b)(1)(iv)(B) of this section), the general exemption contained in paragraph (c)(3) of this section or the last sentence of paragraph (a)(3) of this section, must:

(1) Disclose its reliance on the exemption and its assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of this section in any proxy or information statement for a meeting of shareholders at which directors are elected that is filed with the Commission pursuant to the requirements of section 14 of the Act (*15 U.S.C. 78n*); and

(2) Disclose the information specified in paragraph (d)(1) of this section in, or incorporate such information by reference from such proxy or information statement filed with the Commission into, its annual report filed with the Commission pursuant to the requirements of section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*).

(e) Definitions. Unless the context otherwise requires, all terms used in this section have the same meaning as in the Act. In addition, unless the context otherwise requires, the following definitions apply for purposes of this section:

(1)

(i) The term affiliate of, or a person affiliated with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(ii)

(A) A person will be deemed not to be in control of a specified person for purposes of this section if the person:

(1) Is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and

(2) Is not an executive officer of the specified person.

(B) Paragraph (e)(1)(ii)(A) of this section only creates a safe harbor position that a person does not control a specified person. The existence of the safe harbor does not create a presumption in any way that a person exceeding the ownership requirement in paragraph (e)(1)(ii)(A)(1) of this section controls or is otherwise an affiliate of a specified person.

(iii) The following will be deemed to be affiliates:

(A) An executive officer of an affiliate;

(B) A director who also is an employee of an affiliate;

(C) A general partner of an affiliate; and

(D) A managing member of an affiliate.

(iv) For purposes of paragraph (e)(1)(i) of this section, dual holding companies will not be deemed to be affiliates of or persons affiliated with each other by virtue of their dual holding company arrangements with each other, including where directors of one dual holding company are also directors of the other dual holding company, or where directors of one or both dual holding companies are also directors of the businesses jointly controlled, directly or indirectly, by the dual holding companies (and, in each case, receive only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the dual holding companies or any entity that is jointly controlled, directly or indirectly, by the dual holding companies).

(2) In the case of foreign private issuers with a two-tier board system, the term board of directors means the supervisory or non-management board.

(3) In the case of a listed issuer that is a limited partnership or limited liability company where such entity does not have a board of directors or equivalent body, the term board of directors means the board of directors of the managing general partner, managing member or equivalent body.

(4) The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(5) The term dual holding companies means two foreign private issuers that:

(i) Are organized in different national jurisdictions;

(ii) Collectively own and supervise the management of one or more businesses which are conducted as a single economic enterprise; and

(iii) Do not conduct any business other than collectively owning and supervising such businesses and activities reasonably incidental thereto.

(6) The term executive officer has the meaning set forth in § 240.3b-7.

(7) The term foreign private issuer has the meaning set forth in § 240.3b-4(c).

(8) The term indirect acceptance by a member of an audit committee of any consulting, advisory or other compensatory fee includes acceptance of such a fee by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member or by an entity in which such member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer.

(9) The terms listed and listing refer to securities listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association or to issuers of such securities.

Instructions to § 240.10A-3.

1. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v) and (c)(3)(vi) of this section do not conflict with,

and do not affect the application of, any requirement or ability under a listed issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify such requirements. The requirements instead relate to the assignment of responsibility as between the audit committee and management. In such an instance, however, if the listed issuer provides a recommendation or nomination regarding such responsibilities to shareholders, the audit committee of the listed issuer, or body performing similar functions, must be responsible for making the recommendation or nomination.

2. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v), (c)(3)(vi) and Instruction 1 of this section do not conflict with any legal or listing requirement in a listed issuer's home jurisdiction that prohibits the full board of directors from delegating such responsibilities to the listed issuer's audit committee or limits the degree of such delegation. In that case, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board.

3. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v) and (c)(3)(vi) of this section do not conflict with any legal or listing requirement in a listed issuer's home jurisdiction that vests such responsibilities with a government entity or tribunal. In that case, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law.

4. For purposes of this section, the determination of a person's beneficial ownership must be made in accordance with § 240.13d-3.

Legislative History

HISTORY: [68 FR 18818, April 16, 2003; 70 FR 1620, Jan. 7, 2005; 73 FR 934, 973, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 781, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1). Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections

240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3(a) and 306(a), Pub.L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 781, and 14, Pub.L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 781, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37.; Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Section 240.15b1-3 also issued under sec. 15, 17; 15 U.S.C. 78o 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15c3-3 is also issued under 15 U.S.C. 78o(c)(2), 78(c)(3), 78q(a), 78w(a); sec. 6(c), 84 Stat. 1652; 15 U.S.C. 78fff. Section 240.15c3-3(o) is also issued under Pub.L. 106-554, 114 Stat. 2763, section 203. Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3(a) and 306(a), Pub.L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745.

AUTHORITY: Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub.L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub.L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78o, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1).Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904,

as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 73 FR 934, 973, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, *see* 73 FR 934, Jan. 4, 2008.]



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES

2-D Corporate Governance: Law and Practice Sarbanes-Oxley § 202

§ Oxley 202 Preapproval Requirements [for auditing and non-auditing services adding Section 10A(I) to the Exchange Act]

Section 10A of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1*), as amended by this Act, is amended by adding at the end the following:

"(i) Preapproval Requirements.--

"(1) In general.....

"(A) Audit committee action.--All auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer.

"(B) De minimus exception.--The preapproval requirement under subparagraph (A) is waived with respect to the provision of non-audit services for an issuer, if--

"(i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the nonaudit services are provided;

"(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and

"(iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

"(2) Disclosure to investors.--Approval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 13(a).

"(3) Delegation authority.--The audit committee of an issuer may delegate to 1 or more designated members of the audit committee who are independent directors of the board of directors, the authority to grant preapprovals required by this subsection. The decisions of any member to whom authority is delegated under this paragraph to preapprove an activity under this subsection shall be presented to the full audit committee at each of its scheduled meetings.

"(4) Approval of audit services for other purposes.--In carrying out its duties under subsection (m)(2), if the audit committee of an issuer approves an audit service within the scope of the engagement of the auditor, such audit service shall be deemed to have been preapproved for purposes of this subsection.



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2-D Corporate Governance: Law and Practice Sarbanes-Oxley § 204

§ Oxley 204 Auditor Reports to Audit Committees [adding Section 10A(k) to the Exchange Act]

Section 10A of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1*), as amended by this Act, is amended by adding at the end the following:

(k) Reports to Audit Committees.--Each registered public accounting firm that performs for any issuer any audit required by this title shall timely report to the audit committee of the issuer--

(1) all critical accounting policies and practices to be used;

(2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

(3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.



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2-D Corporate Governance: Law and Practice Sarbanes-Oxley § 301

§ Oxley 301 Public Company Audit Committees [adding Section 10A(m) to the Exchange Act]

Section 10A of the Securities Exchange Act of 1934 (*15 U.S.C. 78f*) (*15 USC 78j-1*) is amended by adding at the end the following:

(m) Standards Relating to Audit Committees.--

(1) Commission rules.....

(A) In general.--Effective not later than 270 days after the date of enactment of this subsection, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraphs (2) through (6).

(B) Opportunity to cure defects.--The rules of the Commission under subparagraph (A) shall provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition under subparagraph (A), before the imposition of such prohibition.

(2) Responsibilities relating to registered public accounting firms.--The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

(3) Independence..... "(A) In general.--Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

(B) Criteria.--In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee--

(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii) be an affiliated person of the issuer or any subsidiary thereof.

(C) Exemption authority.--The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

(4) Complaints.--Each audit committee shall establish procedures for--

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

(5) Authority to engage advisers.--Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

(6) Funding.--Each issuer shall provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation--

(A) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and

(B) to any advisers employed by the audit committee under paragraph (5).



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
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2-D Corporate Governance: Law and Practice Sarbanes-Oxley § 303

§ Oxley 303 Improper Influence on Conduct of Audits

(a) Rules To Prohibit.-- It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

(b) Enforcement.-- In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.

(c) No Preemption of Other Law.-- The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder.

(d) Deadline for Rulemaking.-- The Commission shall--

(1) propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules or regulations required by this section, not later than 270 days after that date of enactment.



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
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2-D Corporate Governance: Law and Practice 17 CFR § 240.13b2-2

§ 2 Representations and conduct in connection with the preparation of required reports and documents.

(a) No director or officer of an issuer shall, directly or indirectly:

(1) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or

(2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with:

(i) Any audit, review or examination of the financial statements of the issuer required to be made pursuant to this subpart; or

(ii) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.

(b)(1) No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have

known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

(2) For purposes of paragraphs (b)(1) and (c)(2) of this section, actions that, "if successful, could result in rendering the issuer's financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an auditor:

(i) To issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards);

(ii) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

(iii) Not to withdraw an issued report; or

(iv) Not to communicate matters to an issuer's audit committee.

(c) In addition, in the case of an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(48)*), no officer or director of the company's investment adviser, sponsor, depositor, trustee, or administrator (or, in the case of paragraph (c)(2) of this section, any other person acting under the direction thereof) shall, directly or indirectly:

(1)

(i) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or

(ii) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with:

(A) Any audit, review, or examination of the financial statements of the investment company required to be made pursuant to this subpart; or

(B) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise; or

(2) Take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that investment company that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the investment company's financial statements materially misleading.

Legislative History

HISTORY: [44 FR 10970, Feb. 23, 1979; 68 FR 31830, May 28, 2003.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1)). Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3,

240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 781, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 781, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 68 FR 31820, 31830, May 28, 2003, revised this section, effective June 27, 2003.]



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Appendix D FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PUBLIC COMPANY
OUTSIDE AUDITORS AND BOARD AUDIT COMMITTEES

2-D Corporate Governance: Law and Practice Sarbanes-Oxley § 407

§ Oxley 407 Disclosure of Audit Committee Financial Expert

(a) Rules Defining "Financial Expert".-- The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to sections 13(a) and 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.

(b) Considerations.-- In defining the term "financial expert" for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions--

(1) an understanding of generally accepted accounting principles and financial statements;

(2) experience in--

(A) the preparation or auditing of financial statements of generally comparable issuers; and

(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience with internal accounting controls; and

(4) an understanding of audit committee functions.

(c) Deadline for Rulemaking.-- The Commission shall--

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules to implement this section, not later than 180 days after that date of enactment.



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2-D Corporate Governance: Law and Practice 17 CFR § 229.407(d)(5)

**§ 401(h) Instructions [Implementing Sarbanes-Oxley § 407 Concerning Disclosures on Audit Committee
Financial Experts]**

(Item 407) Corporate Governance.

* * * * *

(d) Audit Committee.

* * * * *

(5) Audit committee financial expert.

(i)

(A) Disclose that the registrant's board of directors has determined that the registrant either:

(1) Has at least one audit committee financial expert serving on its audit committee; or

(2) Does not have an audit committee financial expert serving on its audit committee.

(B) If the registrant provides the disclosure required by paragraph (d)(5)(i)(A)(1) of this Item, it must disclose the name of the audit committee financial expert and whether that person is independent, as independence for audit committee members is defined in the listing standards applicable to the listed issuer.

(C) If the registrant provides the disclosure required by paragraph (d)(5)(i)(A)(2) of this Item, it must explain why it does not have an audit committee financial expert.

Instruction to Item 407(d)(5)(i).

If the registrant's board of directors has determined that the registrant has more than one audit committee financial expert serving on its audit committee, the registrant may, but is not required to, disclose the names of those additional persons. A registrant choosing to identify such persons must indicate whether they are independent pursuant to paragraph (d)(5)(i)(B) of this Item.

(ii) For purposes of this Item, an audit committee financial expert means a person who has the following attributes:

(A) An understanding of generally accepted accounting principles and financial statements;

(B) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

(C) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;

(D) An understanding of internal control over financial reporting; and

(E) An understanding of audit committee functions.

(iii) A person shall have acquired such attributes through:

(A) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

(B) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

(C) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

(D) Other relevant experience.

(iv) Safe Harbor.

(A) A person who is determined to be an audit committee financial expert will not be deemed an expert for any purpose, including without limitation for purposes of section 11 of the Securities Act of 1933 (*15 U.S.C. 77k*), as a result of being designated or identified as an audit committee financial expert pursuant to this Item 407.

(B) The designation or identification of a person as an audit committee financial expert pursuant to this Item 407 does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification.

(C) The designation or identification of a person as an audit committee financial expert pursuant to this Item 401 does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

Instructions to Item 407(d)(5).

1. The disclosure under paragraph (d)(5) of this Item is required only in a registrant's annual report. The registrant need not provide the disclosure required by paragraph (d)(5) of this Item in a proxy or information statement unless that registrant is electing to incorporate this information by reference from the proxy or information statement into its annual report pursuant to General Instruction G(3) to Form 10-K (17 CFR 249.310).

2. If a person qualifies as an audit committee financial expert by means of having held a position described in paragraph (d)(5)(iii)(D) of this Item, the registrant shall provide a brief listing of that person's relevant experience. Such disclosure may be made by reference to disclosures required under Item 401(e) (§ 229.401(e)).

3. In the case of a foreign private issuer with a two-tier board of directors, for purposes of paragraph (d)(5) of this Item, the term board of directors means the supervisory or non-management board. In the case of a foreign private issuer meeting the requirements of § 240.10A-3(c)(3) of this chapter, for purposes of paragraph (d)(5) of this Item, the term board of directors means the issuer's board of auditors (or similar body) or statutory auditors, as applicable. Also, in the case of a foreign private issuer, the term generally accepted accounting principles in paragraph (d)(5)(ii)(A) of this Item means the body of generally accepted accounting principles used by that issuer in its primary financial statements filed with the Commission.

4. A registrant that is an Asset-Backed Issuer (as defined in § 229.1101) is not required to disclose the information required by paragraph (d)(5) of this Item.

HISTORY: [71 FR 53158, 53254, Sept. 8, 2006; 73 FR 934, 964, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38, 80av39, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted. Section 229.303 is also issued under secs. 3(a) and 401(a), Pub. L. No. 107-204, 116 Stat. 745. Section 229.307 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745. Section 229.401 is also issued under secs. 3(a) and 407, Pub. L. 107-204, 116 Stat. 745. Section 229.406 is also issued under secs. 3(a) and 406, Pub. L. 107-204, 116 Stat. 745. Section 229.601 is also issued under secs. 3(a) and 406, Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 71 FR 53158, 53254, Sept. 8, 2006, added this section, effective Nov. 7, 2006. For compliance date information, see 71 FR 53158, Sept. 8, 2006; 73 FR 934, 964, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, see 73 FR 934, Jan. 4, 2008.]



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2-D Corporate Governance: Law and Practice 17 CFR § 240.14a-101

§ 101 Schedule 14A. Information required in proxy statement.

Schedule 14A Information

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

(Amendment No. _____)

Filed by the Registrant

Filed by a party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material under § 240.14a-12

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

No fee required

Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

Fee paid previously with preliminary materials.

Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

Notes: A. Where any item calls for information with respect to any matter to be acted upon and such matter involves other matters with respect to which information is called for by other items of this schedule, the information called for by such other items also shall be given. For example, where a solicitation of security holders is for the purpose of approving the authorization of additional securities which are to be used to acquire another specified company, and the registrants' security holders will not have a separate opportunity to vote upon the transaction, the solicitation to authorize the securities is also a solicitation with respect to the acquisition. Under those facts, information required by Items 11, 13 and 14 shall be furnished.

B. Where any item calls for information with respect to any matter to be acted upon at the meeting, such item need be answered in the registrant's soliciting material only with respect to proposals to be made by or on behalf of the registrant.

C. Except as otherwise specifically provided, where any item calls for information for a specified period with regard to directors, executive officers, officers or other persons holding specified positions or relationships, the information shall be given with regard to any person who held any of the specified positions or relationship at any time during the period. Information, other than information required by Item 404 of Regulation S-K (§ 229.404 of this chapter), need not be included for any portion of the period during which such person did not hold any such position or relationship, provided a statement to that effect is made.

D. Information may be incorporated by reference only in the manner and to the extent specifically permitted in the items of this schedule. Where incorporation by reference is used, the following shall apply:

1. Any incorporation by reference of information pursuant to the provisions of this schedule shall be subject to the

provisions of § 229.10(d) of this chapter restricting incorporation by reference of documents that incorporate by reference other information. A registrant incorporating any documents, or portions of documents, shall include a statement on the last page(s) of the proxy statement as to which documents, or portions of documents, are incorporated by reference. Information shall not be incorporated by reference in any case where such incorporation would render the statement incomplete, unclear or confusing.

2. If a document is incorporated by reference but not delivered to security holders, include an undertaking to provide, without charge, to each person to whom a proxy statement is delivered, upon written or oral request of such person and by first class mail or other equally prompt means within one business day of receipt of such request, a copy of any and all of the information that has been incorporated by reference in the proxy statement (not including exhibits to the information that is incorporated by reference unless such exhibits are specifically incorporated by reference into the information that the proxy statement incorporates), and the address (including title or department) and telephone numbers to which such a request is to be directed. This includes information contained in documents filed subsequent to the date on which definitive copies of the proxy statement are sent or given to security holders, up to the date of responding to the request.

3. If a document or portion of a document other than an annual report sent to security holders pursuant to the requirements of Rule 14a-3 (§ 240.14a-3 of this chapter) with respect to the same meeting or solicitation of consents or authorizations as that to which the proxy statement relates is incorporated by reference in the manner permitted by Item 13(b) or 14(e)(1) of this schedule, the proxy statement must be sent to security holders no later than 20 business days prior to the date on which the meeting of such security holders is held or, if no meeting is held, at least 20 business days prior to the date the votes, consents or authorizations may be used to effect the corporate action.

4. Electronic filings. If any of the information required by Items 13 or 14 of this Schedule is incorporated by reference from an annual or quarterly report to security holders, such report, or any portion thereof incorporated by reference, shall be filed in electronic format with the proxy statement. This provision shall not apply to registered investment companies.

E. In Item 13 of this Schedule, the reference to "meets the requirement of Form S-3" shall refer to a registrant who meets the following requirements:

(1) The registrant meets the requirements of General Instruction I.A. of Form S-3 (§ 239.13 of this chapter); and

(2) One of the following is met:

(i) The registrant meets the aggregate market value requirement of General Instruction I.B.1 of Form S-3; or

(ii) Action is to be taken as described in Items 11, 12 and 14 of this schedule which concerns non-convertible debt or preferred securities which are "investment grade securities" as defined in General Instruction I.B.2 of Form S-3, except that the time by which the rating must be assigned shall be the date on which definitive copies of the proxy statement are first sent or given to security holders; or

(iii) The registrant is a majority-owned subsidiary and one of the conditions of General Instruction I.C. of Form S-3 is met.

Item 1. Date, time and place information.

(a) State the date, time and place of the meeting of security holders, and the complete mailing address, including ZIP Code, of the principal executive offices of the registrant, unless such information is otherwise disclosed in material furnished to security holders with or preceding the proxy statement. If action is to be taken by written consent, state the date by which consents are to be submitted if state law requires that such a date be specified or if the person soliciting intends to set a date.

(b) On the first page of the proxy statement, as delivered to security holders, state the approximate date on which the proxy statement and form of proxy are first sent or given to security holders.

(c) Furnish the information required to be in the proxy statement by Rule 14a-5(e) (§ 240.14a-5(e) of this chapter).

Item 2. Revocability of proxy. State whether or not the person giving the proxy has the power to revoke it. If the right of revocation before the proxy is exercised is limited or is subject to compliance with any formal procedure, briefly describe such limitation or procedure.

Item 3. Dissenters' right of appraisal. Outline briefly the rights of appraisal or similar rights of dissenters with respect to any matter to be acted upon and indicate any statutory procedure required to be followed by dissenting security holders in order to perfect such rights. Where such rights may be exercised only within a limited time after the date of adoption of a proposal, the filing of a charter amendment or other similar act, state whether the persons solicited will be notified of such date.

Instructions.

1. Indicate whether a security holder's failure to vote against a proposal will constitute a waiver of his appraisal or similar rights and whether a vote against a proposal will be deemed to satisfy any notice requirements under State law with respect to appraisal rights. If the State law is unclear, state what position will be taken in regard to these matters.

2. Open-end investment companies registered under the Investment Company Act of 1940 are not required to respond to this item.

Item 4. Persons Making the Solicitation--

(a) Solicitations not subject to Rule 14a-12(c) (§ 240.14a-12(c)).

(1) If the solicitation is made by the registrant, so state. Give the name of any director of the registrant who has informed the registrant in writing that he intends to oppose any action intended to be taken by the registrant and indicate the action which he intends to oppose.

(2) If the solicitation is made otherwise than by the registrant, so state and give the names of the participants in the solicitation, as defined in paragraphs (a)(iii), (iv), (v) and (vi) of Instruction 3 to this Item.

(3) If the solicitation is to be made otherwise than by the use of the mails, describe the methods to be employed. If the solicitation is to be made by specially engaged employees or paid solicitors, state (i) the material features of any contract or arrangement for such solicitation and identify the parties, and (ii) the cost or anticipated cost thereof.

(4) State the names of the persons by whom the cost of solicitation has been or will be borne, directly or indirectly.

(b) Solicitations subject to Rule 14a-12(c) (§ 240.14a-12(c)).

(1) State by whom the solicitation is made and describe the methods employed and to be employed to solicit security holders.

(2) If regular employees of the registrant or any other participant in a solicitation have been or are to be employed to solicit security holders, describe the class or classes of employees to be so employed, and the manner and nature of their employment for such purpose.

(3) If specially engaged employees, representatives or other persons have been or are to be employed to solicit security holders, state (i) the material features of any contract or arrangement for such solicitation and the identity of the parties, (ii) the cost or anticipated cost thereof and (iii) the approximate number of such employees or any

other person (naming such other person) who will solicit security holders).

(4) State the total amount estimated to be spent and the total expenditures to date for, in furtherance of, or in connection with the solicitation of security holders.

(5) State by whom the cost of the solicitation will be borne. If such cost is to be borne initially by any person other than the registrant, state whether reimbursement will be sought from the registrant, and, if so, whether the question of such reimbursement will be submitted to a vote of security holders.

(6) If any such solicitation is terminated pursuant to a settlement between the registrant and any other participant in such solicitation, describe the terms of such settlement, including the cost or anticipated cost thereof to the registrant.

Instructions.

1. With respect to solicitations subject to Rule 14a-12(c) (§ 240.14a-12(c)), costs and expenditures within the meaning of this Item 4 shall include fees for attorneys, accountants, public relations or financial advisers, solicitors, advertising, printing, transportation, litigation and other costs incidental to the solicitation, except that the registrant may exclude the amount of such costs represented by the amount normally expended for a solicitation for an election of directors in the absence of a contest, and costs represented by salaries and wages of regular employees and officers, provided a statement to that effect is included in the proxy statement.

2. The information required pursuant to paragraph (b)(6) of this Item should be included in any amended or revised proxy statement or other soliciting materials relating to the same meeting or subject matter furnished to security holders by the registrant subsequent to the date of settlement.

3. For purposes of this Item 4 and Item 5 of this Schedule 14A:

(a) The terms "participant" and "participant in a solicitation" include the following:

(i) The registrant;

(ii) Any director of the registrant, and any nominee for whose election as a director proxies are solicited;

(iii) Any committee or group which solicits proxies, any member of such committee or group, and any person whether or not named as a member who, acting alone or with one or more other persons, directly or indirectly takes the initiative, or engages, in organizing, directing, or arranging for the financing of any such committee or group;

(iv) Any person who finances or joins with another to finance the solicitation of proxies, except persons who contribute not more than \$500 and who are not otherwise participants;

(v) Any person who lends money or furnishes credit or enters into any other arrangements, pursuant to any contract or understanding with a participant, for the purpose of financing or otherwise inducing the purchase, sale, holding or voting of securities of the registrant by any participant or other persons, in support of or in opposition to a participant; except that such terms do not include a bank, broker or dealer who, in the ordinary course of business, lends money or executes orders for the purchase or sale of securities and who is not otherwise a participant; and

(vi) Any person who solicits proxies.

(b) The terms "participant" and "participant in a solicitation" do not include:

(i) Any person or organization retained or employed by a participant to solicit security holders and whose activities are limited to the duties required to be performed in the course of such employment;

(ii) Any person who merely transmits proxy soliciting material or performs other ministerial or clerical duties;

(iii) Any person employed by a participant in the capacity of attorney, accountant, or advertising, public relations or financial adviser, and whose activities are limited to the duties required to be performed in the course of such employment;

(iv) Any person regularly employed as an officer or employee of the registrant or any of its subsidiaries who is not otherwise a participant; or

(v) Any officer or director of, or any person regularly employed by, any other participant, if such officer, director or employee is not otherwise a participant.

Item 5. Interest of certain Persons in Matters To Be Acted Upon--

(a) Solicitations not subject to Rule 14a-12(c) (§ 240.14a-12(c)). Describe briefly any substantial interest, direct or

indirect, by security holdings or otherwise, of each of the following persons in any matter to be acted upon, other than elections to office:

(1) If the solicitation is made on behalf of the registrant, each person who has been a director or executive officer of the registrant at any time since the beginning of the last fiscal year.

(2) If the solicitation is made otherwise than on behalf of the registrant, each participant in the solicitation, as defined in paragraphs (a)(iii), (iv), (v), and (vi) of Instruction 3 to Item 4 of this Schedule 14A.

(3) Each nominee for election as a director of the registrant.

(4) Each associate of any of the foregoing persons.

Instruction.

Except in the case of a solicitation subject to this regulation made in opposition to another solicitation subject to this regulation, this sub-item (a) shall not apply to any interest arising from the ownership of securities of the registrant where the security holder receives no extra or special benefit not shared on a pro rata basis by all other holders of the same class.

(b) Solicitation subject to Rule 14a-12(c) (§ 240.14a-12(c)). With respect to any solicitation subject to Rule 14a-12(c) (§ 240.14a-12(c)):

(1) Describe briefly any substantial interest, direct or indirect, by security holdings or otherwise, of each participant as defined in paragraphs (a)(ii), (iii), (iv), (v) and (vi) of Instruction 3 to Item 4 of this Schedule 14A, in any matter to be acted upon at the meeting, and include with respect to each participant the following information, or a fair and accurate summary thereof:

(i) Name and business address of the participant.

(ii) The participant's present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment is carried on.

(iii) State whether or not, during the past ten years, the participant has been convicted in a criminal proceeding

(excluding traffic violations or similar misdemeanors) and, if so, give dates, nature of conviction, name and location of court, and penalty imposed or other disposition of the case. A negative answer need not be included in the proxy statement or other soliciting material.

(iv) State the amount of each class of securities of the registrant which the participant owns beneficially, directly or indirectly.

(v) State the amount of each class of securities of the registrant which the participant owns of record but not beneficially.

(vi) State with respect to all securities of the registrant purchased or sold within the past two years, the dates on which they were purchased or sold and the amount purchased or sold on each such date.

(vii) If any part of the purchase price or market value of any of the shares specified in paragraph (b)(1)(vi) of this Item is represented by funds borrowed or otherwise obtained for the purpose of acquiring or holding such securities, so state and indicate the amount of the indebtedness as of the latest practicable date. If such funds were borrowed or obtained otherwise than pursuant to a margin account or bank loan in the regular course of business of a bank, broker or dealer, briefly describe the transaction, and state the names of the parties.

(viii) State whether or not the participant is, or was within the past year, a party to any contract, arrangements or understandings with any person with respect to any securities of the registrant, including, but not limited to joint ventures, loan or option arrangements, puts or calls, guarantees against loss or guarantees of profit, division of losses or profits, or the giving or withholding of proxies. If so, name the parties to such contracts, arrangements or understandings and give the details thereof.

(ix) State the amount of securities of the registrant owned beneficially, directly or indirectly, by each of the participant's associates and the name and address of each such associate.

(x) State the amount of each class of securities of any parent or subsidiary of the registrant which the participant owns beneficially, directly or indirectly.

(xi) Furnish for the participant and associates of the participant the information required by Item 404(a) of Regulation S-K (§ 229.404(a) of this chapter).

(xii) State whether or not the participant or any associates of the participant have any arrangement or understanding with any person--

(A) with respect to any future employment by the registrant or its affiliates; or

(B) with respect to any future transactions to which the registrant or any of its affiliates will or may be a party.

If so, describe such arrangement or understanding and state the names of the parties thereto.

(2) With respect to any person, other than a director or executive officer of the registrant acting solely in that capacity, who is a party to an arrangement or understanding pursuant to which a nominee for election as director is proposed to be elected, describe any substantial interest, direct or indirect, by security holdings or otherwise, that such person has in any matter to be acted upon at the meeting, and furnish the information called for by paragraphs (b)(1)(xi) and (xii) of this Item.

Instruction:

For purposes of this Item 5, beneficial ownership shall be determined in accordance with Rule 13d-3 under the Act (Section 240.13d-3 of this chapter).

Item 6. Voting securities and principal holders thereof,

(a) As to each class of voting securities of the registrant entitled to be voted at the meeting (or by written consents or authorizations if no meeting is held), state the number of shares outstanding and the number of votes to which each class is entitled.

(b) State the record date, if any, with respect to this solicitation. If the right to vote or give consent is not to be determined, in whole or in part, by reference to a record date, indicate the criteria for the determination of security holders entitled to vote or give consent.

(c) If action is to be taken with respect to the election of directors and if the persons solicited have cumulative voting rights: (1) Make a statement that they have such rights, (2) briefly describe such rights, (3) state briefly the conditions precedent to the exercise thereof, and (4) if discretionary authority to cumulate votes is solicited, so indicate.

(d) Furnish the information required by Item 403 of Regulation S-K (§ 229.403 of this chapter) to the extent known by the persons on whose behalf the solicitation is made.

(e) If, to the knowledge of the persons on whose behalf the solicitation is made, a change in control of the registrant

has occurred since the beginning of its last fiscal year, state the name of the person(s) who acquired such control, the amount and the source of the consideration used by such person or persons; the basis of the control, the date and a description of the transaction(s) which resulted in the change of control and the percentage of voting securities of the registrant now beneficially owned directly or indirectly by the person(s) who acquired control; and the identity of the person(s) from whom control was assumed. If the source of all or any part of the consideration used is a loan made in the ordinary course of business by a bank as defined by section 3(a)(6) of the Act, the identity of such bank shall be omitted provided a request for confidentiality has been made pursuant to section 13(d)(1)(B) of the Act by the person(s) who acquired control. In lieu thereof, the material shall indicate that the identity of the bank has been so omitted and filed separately with the Commission.

Instruction.

1. State the terms of any loans or pledges obtained by the new control group for the purpose of acquiring control, and the names of the lenders or pledgees.

2. Any arrangements or understandings among members of both the former and new control groups and their associates with respect to election of directors or other matters should be described.

Item 7. Directors and executive officers. If action is to be taken with respect to the election of directors, furnish the following information in tabular form to the extent practicable. If, however, the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation.

(a) The information required by instruction 4 to Item 103 of Regulation S-K (§ 229.103 of this chapter) with respect to directors and executive officers.

(b) The information required by Items 401, 404(a) and (b), 405 and 407(d)(4) and (d)(5) of Regulation S-K (§ 229.401, § 229.404(a) and (b), § 229.405 and § 229.407(d)(4) and (d)(5) of this chapter).

(c) The information required by Item 407(a) of Regulation S-K (§ 229.407 of this chapter).

(d) The information required by Item 407(b), (c)(1), (c)(2), (d)(1), (d)(2), (d)(3), (e)(1), (e)(2), (e)(3) and (f) of Regulation S-K (§ 229.407(b), (c)(1), (c)(2), (d)(1), (d)(2), (d)(3), (e)(1), (e)(2), (e)(3) and (f) of this chapter).

(e) In lieu of the information required by this Item 7, investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a) must furnish the information required by Item 22(b) of this Schedule 14A.

Item 8. Compensation of directors and executive officers.

Furnish the information required by Item 402 of Regulation S-K (§ 229.402 of this chapter) and paragraphs (e)(4) and (e)(5) of Item 407 of Regulation S-K (§ 229.407(e)(4) and (e)(5) of this chapter) if action is to be taken with regard to:

(a) The election of directors;

(b) Any bonus, profit sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the registrant will participate;

(c) Any pension or retirement plan in which any such person will participate; or

(d) The granting or extension to any such person of any options, warrants or rights to purchase any securities, other than warrants or rights issued to security holders as such, on a pro rata basis.

However, if the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation and associates of such nominees. In the case of investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a), furnish the information required by Item 22(b)(13) of this Schedule 14A.

Instruction. If an otherwise reportable compensation plan became subject to such requirements because of an acquisition or merger and, within one year of the acquisition or merger, such plan was terminated for purposes of prospective eligibility, the registrant may furnish a description of its obligation to the designated individuals pursuant to the compensation plan. Such description may be furnished in lieu of a description of the compensation plan in the proxy statement.

Item 9. Independent public accountants. If the solicitation is made on behalf of the registrant and relates to: (1) The annual (or special meeting in lieu of annual) meeting of security holders at which directors are to be elected, or a solicitation of consents or authorizations in lieu of such meeting or (2) the election, approval or ratification of the registrant's accountant, furnish the following information describing the registrant's relationship with its independent public accountant:

(a) The name of the principal accountant selected or being recommended to security holders for election, approval or ratification for the current year. If no accountant has been selected or recommended, so state and briefly describe the reasons therefor.

(b) The name of the principal accountant for the fiscal year most recently completed if different from the accountant selected or recommended for the current year or if no accountant has yet been selected or recommended for the current year.

(c) The proxy statement shall indicate: (1) Whether or not representatives of the principal accountant for the current year and for the most recently completed fiscal year are expected to be present at the security holders' meeting, (2) whether or not they will have the opportunity to make a statement if they desire to do so, and (3) whether or not such representatives are expected to be available to respond to appropriate questions.

(d) If during the registrant's two most recent fiscal years or any subsequent interim period, (1) an independent accountant who was previously engaged as the principal accountant to audit the registrant's financial statements, or an independent accountant on whom the principal accountant expressed reliance in its report regarding a significant subsidiary, has resigned (or indicated it has declined to stand for re-election after the completion of the current audit) or was dismissed, or (2) a new independent accountant has been engaged as either the principal accountant to audit the registrant's financial statements or as an independent accountant on whom the principal accountant has expressed or is expected to express reliance in its report regarding a significant subsidiary, then, notwithstanding any previous disclosure, provide the information required by Item 304(a) of Regulation S-K (§ 229.304 of this chapter).

(e)

(1) Disclose, under the caption Audit Fees, the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's Form 10-Q (*17 CFR 249.308a*) or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

(2) Disclose, under the caption Audit-Related Fees, the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(3) Disclose, under the caption Tax Fees, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(4) Disclose, under the caption All Other Fees, the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe the nature of the services comprising the fees disclosed under this category.

(5)

(i) Disclose the audit committee's pre-approval policies and procedures described in *17 CFR 210.2-01(c)(7)(i)*.

(ii) Disclose the percentage of services described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to *17 CFR 210.2-01(c)(7)(i)(C)*.

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

(7) If the registrant is an investment company, disclose the aggregate non-audit fees billed by the registrant's accountant for services rendered to the registrant, and to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides ongoing services to the registrant for each of the last two fiscal years of the registrant.

(8) If the registrant is an investment company, disclose whether the audit committee of the board of directors has considered whether the provision of non-audit services that were rendered to the registrant's investment adviser (not including any subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant that were not pre-approved pursuant to *17 CFR 210.2-01(c)(7)(ii)* is compatible with maintaining the principal accountant's independence.

Instruction to Item 9(e).

For purposes of Item 9(e)(2), (3), and (4), registrants that are investment companies must disclose fees billed for services rendered to the registrant and separately, disclose fees required to be approved by the investment company registrant's audit committee pursuant to *17 CFR 210.2-01(c)(7)(ii)*. Registered investment companies must also disclose the fee percentages as required by item 9(e)(5)(ii) for the registrant and separately, disclose the fee percentages as required by item 9(e)(5)(ii) for the fees required to be approved by the investment company registrant's audit committee pursuant to *17 CFR 210.2-01(c)(7)(ii)*.

Item 10. Compensation Plans. If action is to be taken with respect to any plan pursuant to which cash or noncash compensation may be paid or distributed, furnish the following information:

(a) Plans subject to security holder action.

(1) Describe briefly the material features of the plan being acted upon, identify each class of persons who will be

eligible to participate therein, indicate the approximate number of persons in each such class, and state the basis of such participation.

(2)

(i) In the tabular format specified below, disclose the benefits or amounts that will be received by or allocated to each of the following under the plan being acted upon, if such benefits or amounts are determinable:

New Plan Benefits

Plan name _____

Name and position	Dollar value (]	Number of units
-------------------	-----------------	-----------------

CEO.

A.

B.

C.

D.

Executive Group.

Non-Executive Director Group.

Non-Executive Officer Employee Group.

(ii) The table required by paragraph (a)(2)(i) of this Item shall provide information as to the following persons:

(A) Each person (stating name and position) specified in paragraph (a)(3) of Item 402 of Regulation S-K (§ 229.402(a)(3) of this chapter);

Instruction: In the case of investment companies registered under the Investment Company Act of 1940, furnish the information for Compensated Persons as defined in Item 22(b)(13) of this Schedule in lieu of the persons specified in paragraph (a)(3) of Item 402 of Regulation S-K (§ 229.402(a)(3) of this chapter).

(B) All current executive officers as a group;

(C) All current directors who are not executive officers as a group; and

(D) All employees, including all current officers who are not executive officers, as a group.

Instruction to New Plan Benefits Table

Additional columns should be added for each plan with respect to which security holder action is to be taken.

(iii) If the benefits or amounts specified in paragraph (a)(2)(i) of this item are not determinable, state the benefits or amounts which would have been received by or allocated to each of the following for the last completed fiscal year if the plan had been in effect, if such benefits or amounts may be determined, in the table specified in paragraph (a)(2)(i) of this Item:

(A) Each person (stating name and position) specified in paragraph (a)(3) of Item 402 of Regulation S-K (§ 229.402(a)(3) of this chapter);

(B) All current executive officers as a group;

(C) All current directors who are not executive officers as a group; and

(D) All employees, including all current officers who are not executive officers, as a group.

(3) If the plan to be acted upon can be amended, otherwise than by a vote of security holders, to increase the cost thereof to the registrant or to alter the allocation of the benefits as between the persons and groups specified in paragraph (a)(2) of this item, state the nature of the amendments which can be so made.

(b)

(1) Additional information regarding specified plans subject to security holder action. With respect to any pension or retirement plan submitted for security holder action, state:

(i) The approximate total amount necessary to fund the plan with respect to past services, the period over which such amount is to be paid and the estimated annual payments necessary to pay the total amount over such period; and

(ii) The estimated annual payment to be made with respect to current services. In the case of a pension or retirement plan, information called for by paragraph (a)(2) of this Item may be furnished in the format specified by

paragraph (h)(2) of Item 402 of Regulation S-K (§ 229.402(h)(2) of this chapter).

Instruction to paragraph (b)(1)(ii).

In the case of investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a), refer to Instruction 4 in Item 22(b)(13)(i) of this Schedule in lieu of paragraph (h)(2) of Item 402 of Regulation S-K (§ 229.402(h)(2) of this chapter).

(2)

(i) With respect to any specific grant of or any plan containing options, warrants or rights submitted for security holder action, state:

(A) The title and amount of securities underlying such options, warrants or rights;

(B) The prices, expiration dates and other material conditions upon which the options, warrants or rights may be exercised;

(C) The consideration received or to be received by the registrant or subsidiary for the granting or extension of the options, warrants or rights;

(D) The market value of the securities underlying the options, warrants, or rights as of the latest practicable date; and

(E) In the case of options, the federal income tax consequences of the issuance and exercise of such options to the recipient and the registrant; and

(ii) State separately the amount of such options received or to be received by the following persons if such benefits or amounts are determinable:

(A) Each person (stating name and position) specified in paragraph (a)(3) of Item 402 of Regulation S-K (§ 229.402(a)(3) of this chapter);

(B) All current executive officers as a group;

- (C) All current directors who are not executive officers as a group;
- (D) Each nominee for election as a director;
- (E) Each associate of any of such directors, executive officers or nominees;
- (F) Each other person who received or is to receive 5 percent of such options, warrants or rights; and
- (G) All employees, including all current officers who are not executive officers, as a group.

(c) Information regarding plans and other arrangements not subject to security holder action. Furnish the information required by Item 201(d) of Regulation S-K (§ 229.201(d) of this chapter).

Instructions to paragraph (c).

1. If action is to be taken as described in paragraph (a) of this Item with respect to the approval of a new compensation plan under which equity securities of the registrant are authorized for issuance, information about the plan shall be disclosed as required under paragraphs (a) and (b) of this Item and shall not be included in the disclosure required by Item 201(d) of Regulation S-K (§ 229.201(d) of this chapter). If action is to be taken as described in paragraph (a) of this Item with respect to the amendment or modification of an existing plan under which equity securities of the registrant are authorized for issuance, the registrant shall include information about securities previously authorized for issuance under the plan (including any outstanding options, warrants and rights previously granted pursuant to the plan and any securities remaining available for future issuance under the plan) in the disclosure required by Item 201(d) of Regulation S-K (§ 229.201(d) of this chapter). Any additional securities that are the subject of the amendments or modification of the existing plan shall be disclosed as required under paragraphs (a) and (b) of this Item and shall not be included in the Item 201(d) disclosure.

Instructions

1. The term plan as used in this Item means any plan as defined in paragraph (a)(6)(ii) of Item 402 of Regulation S-K (§ 229.402(a)(6)(ii) of this chapter).

2. If action is to be taken with respect to a material amendment or modification of an existing plan, the item shall be answered with respect to the plan as proposed to be amended or modified and shall indicate any material differences from the existing plan.

3. If the plan to be acted upon is set forth in a written document, three copies thereof shall be filed with the Commission at the time copies of the proxy statement and form of proxy are first filed pursuant to paragraph (a) or (b) of § 240.14a-6. Electronic filers shall file with the Commission a copy of such written plan document in electronic format as an appendix to the proxy statement. It need not be provided to security holders unless it is a part of the proxy

statement.

4. Paragraph (b)(2)(ii) does not apply to warrants or rights to be issued to security holders as such on a pro rata basis.

5. The Commission shall be informed, as supplemental information, when the proxy statement is first filed, as to when the options, warrants or rights and the shares called for thereby will be registered under the Securities Act or, if such registration is not contemplated, the section of the Securities Act or rule of the Commission under which exemption from such registration is claimed and the facts relied upon to make the exemption available.

Item 11. Authorization or issuance of securities otherwise than for exchange. If action is to be taken with respect to the authorization or issuance of any securities otherwise than for exchange for outstanding securities of the registrant, furnish the following information:

(a) State the title and amount of securities to be authorized or issued.

(b) Furnish the information required by Item 202 of Regulation S-K (§ 229.202 of this chapter). If the terms of the securities cannot be stated or estimated with respect to any or all of the securities to be authorized, because no offering thereof is contemplated in the proximate future, and if no further authorization by security holders for the issuance thereof is to be obtained, it should be stated that the terms of the securities to be authorized, including dividend or interest rates, conversion prices, voting rights, redemption prices, maturity dates, and similar matters will be determined by the board of directors. If the securities are additional shares of common stock of a class outstanding, the description may be omitted except for a statement of the preemptive rights, if any. Where the statutory provisions with respect to preemptive rights are so indefinite or complex that they cannot be stated in summarized form, it will suffice to make a statement in the form of an opinion of counsel as to the existence and extent of such rights.

(c) Describe briefly the transaction in which the securities are to be issued including a statement as to (1) the nature and approximate amount of consideration received or to be received by the registrant and (2) the approximate amount devoted to each purpose so far as determinable for which the net proceeds have been or are to be used. If it is impracticable to describe the transaction in which the securities are to be issued, state the reason, indicate the purpose of the authorization of the securities, and state whether further authorization for the issuance of the securities by a vote of security holders will be solicited prior to such issuance.

(d) If the securities are to be issued otherwise than in a public offering for cash, state the reasons for the proposed authorization or issuance and the general effect thereof upon the rights of existing security holders.

(e) Furnish the information required by Item 13(a) of this schedule.

Item 12. Modification or exchange of securities. If action is to be taken with respect to the modification of any class of securities of the registrant, or the issuance or authorization for issuance of securities of the registrant in exchange for outstanding securities of the registrant furnish the following information:

(a) If outstanding securities are to be modified, state the title and amount thereof. If securities are to be issued in exchange for outstanding securities, state the title and amount of securities to be so issued, the title and amount of outstanding securities to be exchanged therefor and the basis of the exchange.

(b) Describe any material differences between the outstanding securities and the modified or new securities in respect of any of the matters concerning which information would be required in the description of the securities in Item 202 of Regulation S-K (§ 229.202 of this chapter).

(c) State the reasons for the proposed modification or exchange and the general effect thereof upon the rights of existing security holders.

(d) Furnish a brief statement as to arrears in dividends or as to defaults in principal or interest in respect to the outstanding securities which are to be modified or exchanged and such other information as may be appropriate in the particular case to disclose adequately the nature and effect of the proposed action.

(e) Outline briefly any other material features of the proposed modification or exchange. If the plan of proposed action is set forth in a written document, file copies thereof with the Commission in accordance with § 240.14a-6.

(f) Furnish the information required by Item 13(a) of this Schedule.

Instruction. If the existing security is presently listed and registered on a national securities exchange, state whether the registrant intends to apply for listing and registration of the new or reclassified security on such exchange or any other exchange. If the registrant does not intend to make such application, state the effect of the termination of such listing and registration.

Item 13. Financial and other information. (See Notes D and E at the beginning of this Schedule.)

(a) Information required. If action is to be taken with respect to any matter specified in Item 11 or 12, furnish the following information:

(1) Financial statements meeting the requirements of Regulation S-X, including financial information required by Rule 3-05 and Article 11 of Regulation S-X with respect to transactions other than pursuant to which action is to be taken as described in this proxy statement (A smaller reporting company may provide the information in Rules 8-04 and 8-05 of Regulation S-X (§ 210.8-04 and § 210.8-05 of this chapter) in lieu of the financial information required by Rule 3-05 and Article 11 of Regulation S-X);

(2) Item 302 of Regulation S-K, supplementary financial information;

(3) Item 303 of Regulation S-K, management's discussion and analysis of financial condition and results of operations;

(4) Item 304 of Regulation S-K, changes in and disagreements with accountants on accounting and financial disclosure;

(5) Item 305 of Regulation S-K, quantitative and qualitative disclosures about market risk; and

(6) A statement as to whether or not representatives of the principal accountants for the current year and for the most recently completed fiscal year:

(i) Are expected to be present at the security holders' meeting;

(ii) Will have the opportunity to make a statement if they desire to do so; and

(iii) Are expected to be available to respond to appropriate questions.

(b) Incorporation by reference. The information required pursuant to paragraph (a) of this Item may be incorporated by reference into the proxy statement as follows:

(1) S-3 registrants. If the registrant meets the requirements of Form S-3 (see Note E to this Schedule), it may incorporate by reference to previously-filed documents any of the information required by paragraph (a) of this Item, provided that the requirements of paragraph (c) are met. Where the registrant meets the requirements of Form S-3 and has elected to furnish the required information by incorporation by reference, the registrant may elect to update the

information so incorporated by reference to information in subsequently-filed documents.

(2) All registrants. The registrant may incorporate by reference any of the information required by paragraph (a) of this Item, provided that the information is contained in an annual report to security holders or a previously-filed statement or report, such report or statement is delivered to security holders with the proxy statement and the requirements of paragraph (c) are met.

(c) Certain conditions applicable to incorporation by reference. Registrants eligible to incorporate by reference into the proxy statement the information required by paragraph (a) of this Item in the manner specified by paragraphs (b)(1) and (b)(2) may do so only if:

(1) The information is not required to be included in the proxy statement pursuant to the requirement of another Item;

(2) The proxy statement identifies on the last page(s) the information incorporated by reference; and

(3) The material incorporated by reference substantially meets the requirements of this Item or the appropriate portions of this Item.

Instructions to Item 13.

1. Notwithstanding the provisions of this Item, any or all of the information required by paragraph (a) of this Item not material for the exercise of prudent judgment in regard to the matter to be acted upon may be omitted. In the usual case the information is deemed material to the exercise of prudent judgment where the matter to be acted upon is the authorization or issuance of a material amount of senior securities, but the information is not deemed material where the matter to be acted upon is the authorization or issuance of common stock, otherwise than in an exchange, merger, consolidation, acquisition or similar transaction, the authorization of preferred stock without present intent to issue or the authorization of preferred stock for issuance for cash in an amount constituting fair value.

2. In order to facilitate compliance with Rule 2-02(a) of Regulation S-X, one copy of the definitive proxy statement filed with the Commission shall include a manually signed copy of the accountant's report. If the financial statements are incorporated by reference, a manually signed copy of the accountant's report shall be filed with the definitive proxy statement.

3. Notwithstanding the provisions of Regulation S-X, no schedules other than those prepared in accordance with Rules 12-15, 12-28 and 12-29 (or, for management investment companies, Rules 12-12 through 12-14) of that regulation need be furnished in the proxy statement.

4. Unless registered on a national securities exchange or otherwise required to furnish such information, registered investment companies need not furnish the information required by paragraph (a)(2) or (3) of this Item.

5. If the registrant submits preliminary proxy material incorporating by reference financial statements required by

this Item, the registrant should furnish a draft of the financial statements if the document from which they are incorporated has not been filed with or furnished to the Commission.

6. A registered investment company need not comply with items (a)(2), (a)(3), and (a)(5) of this Item 13.

Item 14. Mergers, consolidations, acquisitions and similar matters. (See Notes A and D at the beginning of this Schedule.)

Instructions to Item 14.

1. In transactions in which the consideration offered to security holders consists wholly or in part of securities registered under the Securities Act of 1933, furnish the information required by Form S-4 (§ 239.25 of this chapter), Form F-4 (§ 239.34 of this chapter), or Form N-14 (§ 239.23 of this chapter), as applicable, instead of this Item. Only a Form S-4, Form F-4, or Form N-14 must be filed in accordance with § 240.14a-6(j).

2. (a) In transactions in which the consideration offered to security holders consists wholly of cash, the information required by paragraph (c)(1) of this Item for the acquiring company need not be provided unless the information is material to an informed voting decision (e.g., the security holders of the target company are voting and financing is not assured).

(b) Additionally, if only the security holders of the target company are voting:

i. The financial information in paragraphs (b)(8)-(11) of this Item for the acquiring company and the target need not be provided; and

ii. The information in paragraph (c)(2) of this Item for the target company need not be provided.

If, however, the transaction is a going-private transaction (as defined by § 240.13e-3), then the information required by paragraph (c)(2) of this Item must be provided and to the extent that the going-private rules require the information specified in paragraph (b)(8)-(b)(11) of this Item, that information must be provided as well.

3. In transactions in which the consideration offered to security holders consists wholly of securities exempt from registration under the Securities Act of 1933 or a combination of exempt securities and cash, information about the acquiring company required by paragraph (c)(1) of this Item need not be provided if only the security holders of the acquiring company are voting, unless the information is material to an informed voting decision. If only the security holders of the target company are voting, information about the target company in paragraph (c)(2) of this Item need not be provided. However, the information required by paragraph (c)(2) of this Item must be provided if the transaction is a going-private (as defined by § 240.13e-3) or roll-up (as described by Item 901 of Regulation S-K (§ 229.901 of this chapter)) transaction.

4. The information required by paragraphs (b)(8)-(11) and (c) need not be provided if the plan being voted on involves only the acquiring company and one or more of its totally held subsidiaries and does not involve a liquidation or a spin-off.

5. To facilitate compliance with Rule 2-02(a) of Regulation S-X (§ 210.2-02(a) of this chapter) (technical requirements relating to accountants' reports), one copy of the definitive proxy statement filed with the Commission must include a signed copy of the accountant's report. If the financial statements are incorporated by reference, a signed copy of the accountant's report must be filed with the definitive proxy statement. Signatures may be typed if the document is filed electronically on EDGAR. See Rule 302 of Regulation S-T (§ 232.302 of this chapter).

6. Notwithstanding the provisions of Regulation S-X, no schedules other than those prepared in accordance with § 210.12-15, § 210.12-28 and § 210.12-29 of this chapter (or, for management investment companies, § § 210.12-12 through 210.12-14 of this chapter) of that regulation need be furnished in the proxy statement.

7. If the preliminary proxy material incorporates by reference financial statements required by this Item, a draft of the financial statements must be furnished to the Commission staff upon request if the document from which they are incorporated has not been filed with or furnished to the Commission.

(a) Applicability. If action is to be taken with respect to any of the following transactions, provide the information required by this Item:

(1) Summary term sheet. The information required by Item 1001 of Regulation M-A (§ 229.1001 of this chapter).

(2) Contact information. The name, complete mailing address and telephone number of the principal executive offices.

(3) Business conducted. A brief description of the general nature of the business conducted.

(4) Terms of the transaction. The information required by Item 1004(a)(2) of Regulation M-A (§ 229.1004 of this chapter).

(5) Regulatory approvals. A statement as to whether any federal or state regulatory requirements must be complied with or approval must be obtained in connection with the transaction and, if so, the status of the compliance or approval.

(6) Reports, opinions, appraisals. If a report, opinion or appraisal materially relating to the transaction has been received from an outside party, and is referred to in the proxy statement, furnish the information required by Item 1015(b) of Regulation M-A (§ 229.1015 of this chapter).

(7) Past contacts, transactions or negotiations. The information required by Items 1005(b) and 1011(a)(1) of Regulation M-A (§ 229.1005 of this chapter and § 229.1011 of this chapter), for the parties to the transaction and their affiliates during the periods for which financial statements are presented or incorporated by reference under this Item.

(8) Selected financial data. The selected financial data required by Item 301 of Regulation S-K (§ 229.301 of this chapter).

(9) Pro forma selected financial data. If material, the information required by Item 301 of Regulation S-K (§ 229.301 of this chapter) for the acquiring company, showing the pro forma effect of the transaction.

(10) Pro forma information. In a table designed to facilitate comparison, historical and pro forma per share data of the acquiring company and historical and equivalent pro forma per share data of the target company for the following Items:

(i) Book value per share as of the date financial data is presented pursuant to Item 301 of Regulation S-K (§ 229.301 of this chapter);

(ii) Cash dividends declared per share for the periods for which financial data is presented pursuant to Item 301 of Regulation S-K (§ 229.301 of this chapter); and

(iii) Income (loss) per share from continuing operations for the periods for which financial data is presented pursuant to Item 301 of Regulation S-K (§ 229.301 of this chapter).

Instructions to paragraphs (b)(8), (b)(9) and (b)(10):

1. For a business combination accounted for as a purchase, present the financial information required by paragraphs (b)(9) and (b)(10) only for the most recent fiscal year and interim period. For a business combination accounted for as a pooling, present the financial information required by paragraphs (b)(9) and (b)(10) (except for information with regard to book value) for the most recent three fiscal years and interim period. For purposes of these paragraphs, book value information need only be provided for the most recent balance sheet date.

2. Calculate the equivalent pro forma per share amounts for one share of the company being acquired by multiplying the exchange ratio times each of:

(i) The pro forma income (loss) per share before non-recurring charges or credits directly attributable to the transaction;

(ii) The pro forma book value per share; and

(iii) The pro forma dividends per share of the acquiring company.

3. Unless registered on a national securities exchange or otherwise required to furnish such information, registered investment companies need not furnish the information required by paragraphs (b)(8) and (b)(9) of this Item.

(11) Financial information. If material, financial information required by Article 11 of Regulation S-X (§ § 210.10-01 through 229.11-03 of this chapter) with respect to this transaction.

Instructions to paragraph (b)(11):

1. Present any Article 11 information required with respect to transactions other than those being voted upon (where not incorporated by reference) together with the pro forma information relating to the transaction being voted upon. In presenting this information, you must clearly distinguish between the transaction being voted upon and any other transaction.

2. If current pro forma financial information with respect to all other transactions is incorporated by reference, you need only present the pro forma effect of this transaction.

(c) Information about the parties to the transaction.

(1) Acquiring company. Furnish the information required by Part B (Registrant Information) of Form S-4 (§ 239.25 of this chapter) or Form F-4 (§ 239.34 of this chapter), as applicable, for the acquiring company. However, financial statements need only be presented for the latest two fiscal years and interim periods.

(2) Acquired company. Furnish the information required by Part C (Information with Respect to the Company Being Acquired) of Form S-4 (§ 239.25 of this chapter) or Form F-4 (§ 239.34 of this chapter), as applicable.

(d) Information about parties to the transaction: registered investment companies and business development companies. If the acquiring company or the acquired company is an investment company registered under the Investment Company Act of 1940 or a business development company as defined by Section 2(a)(48) of the Investment Company Act of 1940, provide the following information for that company instead of the information specified by paragraph (c) of this Item:

(1) Information required by Item 101 of Regulation S-K (§ 229.101 of this chapter), description of business;

(2) Information required by Item 102 of Regulation S-K (§ 229.102 of this chapter), description of property;

(3) Information required by Item 103 of Regulation S-K (§ 229.103 of this chapter), legal proceedings;

(4) Information required by Item 201(a), (b) and (c) of Regulation S-K (§ 229.201(a), (b) and (c) of this chapter), market price of and dividends on the registrant's common equity and related stockholder matters;

(5) Financial statements meeting the requirements of Regulation S-X, including financial information required by Rule 3-05 and Article 11 of Regulation S-X (§ 210.3-05 and § 210.11-01 through § 210.11-03 of this chapter) with respect to transactions other than that as to which action is to be taken as described in this proxy statement;

(6) Information required by Item 301 of Regulation S-K (§ 229.301 of this chapter), selected financial data;

(7) Information required by Item 302 of Regulation S-K (§ 229.302 of this chapter), supplementary financial information;

(8) Information required by Item 303 of Regulation S-K (§ 229.303 of this chapter), management's discussion and analysis of financial condition and results of operations; and

(9) Information required by Item 304 of Regulation S-K (§ 229.304 of this chapter), changes in and disagreements with accountants on accounting and financial disclosure.

Instruction to paragraph (d) of Item 14: Unless registered on a national securities exchange or otherwise required to furnish such information, registered investment companies need not furnish the information required by paragraphs (d)(6), (d)(7) and (d)(8) of this Item.

(e) Incorporation by reference.

(1) The information required by paragraph (c) of this section may be incorporated by reference into the proxy statement to the same extent as would be permitted by Form S-4 (§ 239.25 of this chapter) or Form F-4 (§ 239.34 of this chapter), as applicable.

(2) Alternatively, the registrant may incorporate by reference into the proxy statement the information required by paragraph (c) of this Item if it is contained in an annual report sent to security holders in accordance with § 240.14a-3 of this chapter with respect to the same meeting or solicitation of consents or authorizations that the proxy statement relates to and the information substantially meets the disclosure requirements of Item 14 or Item 17 of Form S-4 (§ 239.25 of this chapter) or Form F-4 (§ 239.34 of this chapter), as applicable.

Item 15. Acquisition or disposition of property. If action is to be taken with respect to the acquisition or disposition of any property, furnish the following information:

(a) Describe briefly the general character and location of the property.

(b) State the nature and amount of consideration to be paid or received by the registrant or any subsidiary. To the extent practicable, outline briefly the facts bearing upon the question of the fairness of the consideration.

(c) State the name and address of the transferor or transferee, as the case may be and the nature of any material relationship of such person to the registrant or any affiliate of the registrant.

(d) Outline briefly any other material features of the contract or transaction.

Item 16. Restatement of accounts. If action is to be taken with respect to the restatement of any asset, capital, or surplus account of the registrant furnish the following information:

(a) State the nature of the restatement and the date as of which it is to be effective.

(b) Outline briefly the reasons for the restatement and for the selection of the particular effective date.

(c) State the name and amount of each account (including any reserve accounts) affected by the restatement and the effect of the restatement thereon. Tabular presentation of the amounts shall be made when appropriate, particularly in the case of recapitalizations.

(d) To the extent practicable, state whether and the extent, if any, to which, the restatement will, as of the date thereof, alter the amount available for distribution to the holders of equity securities.

Item 17. Action with respect to reports. If action is to be taken with respect to any report of the registrant or of its directors, officers or committees or any minutes of a meeting of its security holders, furnish the following information:

(a) State whether or not such action is to constitute approval or disapproval of any of the matters referred to in such reports or minutes.

(b) Identify each of such matters which it is intended will be approved or disapproved, and furnish the information required by the appropriate item or items of this schedule with respect to each such matter.

Item 18. Matters not required to be submitted. If action is to be taken with respect to any matter which is not required to be submitted to a vote of security holders, state the nature of such matter, the reasons for submitting it to a vote of security holders and what action is intended to be taken by the registrant in the event of a negative vote on the matter by the security holders.

Item 19. Amendment of character, bylaws or other documents. If action is to be taken with respect to any amendment of the registrant's charter, bylaws or other documents as to which information is not required above, state briefly the reasons for and the general effect of such amendment.

Instructions.

1. Where the matter to be acted upon is the classification of directors, state whether vacancies which occur during the year may be filled by the board of directors to serve only until the next annual meeting or may be so filled for the remainder of the full term.

2. Attention is directed to the discussion of disclosure regarding anti-takeover and similar proposals in Release No. 34-15230 (October 13, 1978).

Item 20. Other proposed action. If action is to be taken on any matter not specifically referred to in this Schedule 14A, describe briefly the substance of each such matter in substantially the same degree of detail as is required by Items 5 to 19, inclusive, of this Schedule, and, with respect to investment companies registered under the Investment Company Act of 1940, Item 22 of this Schedule.

Item 21. Voting Procedures. As to each matter which is to be submitted to a vote of security holders, furnish the following information:

(a) State the vote required for approval or election, other than for the approval of auditors.

(b) Disclose the method by which votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law as well as registrant charter and by-law provisions.

Item 22. Information required in investment company proxy statement.

(a) General.

(1) Definitions. Unless the context otherwise requires, terms used in this Item that are defined in § 240.14a-1 (with respect to proxy soliciting material), in § 240.14c-1 (with respect to information statements), and in the Investment Company Act of 1940 shall have the same meanings provided therein and the following terms shall also apply:

(i) Administrator. The term "Administrator" shall mean any person who provides significant administrative or business affairs management services to a Fund.

(ii) Affiliated broker. The term "Affiliated Broker" shall mean any broker:

(A) That is an affiliated person of the Fund;

(B) That is an affiliated person of such person; or

(C) An affiliated person of which is an affiliated person of the Fund, its investment adviser, principal underwriter, or Administrator.

(iii) Distribution plan. The term "Distribution Plan" shall mean a plan adopted pursuant to Rule 12b-1 under the Investment Company Act of 1940 (§ 270.12b-1 of this chapter).

(iv) Family of Investment Companies. The term "Family of Investment Companies" shall mean any two or more registered investment companies that:

(A) Share the same investment adviser or principal underwriter; and

(B) Hold themselves out to investors as related companies for purposes of investment and investor services.

(v) Fund. The term "Fund" shall mean a Registrant or, where the Registrant is a series company, a separate portfolio of the Registrant.

(vi) Fund complex. The term "Fund Complex" shall mean two or more Funds that:

(A) Hold themselves out to investors as related companies for purposes of investment and investor services; or

(B) Have a common investment adviser or have an investment adviser that is an affiliated person of the investment adviser of any of the other Funds.

(vii) Immediate Family Member. The term "Immediate Family Member" shall mean a person's spouse; child residing in the person's household (including step and adoptive children); and any dependent of the person, as defined in *section 152 of the Internal Revenue Code (26 U.S.C. 152)*.

(viii) Officer. The term "Officer" shall mean the president, vice-president, secretary, treasurer, controller, or any other officer who performs policy-making functions.

(ix) Parent. The term "Parent" shall mean the affiliated person of a specified person who controls the specified person directly or indirectly through one or more intermediaries.

(x) Registrant. The term "Registrant" shall mean an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a) or a business development company as defined by section 2(a)(48) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(48)*).

(xi) Sponsoring Insurance Company. The term "Sponsoring Insurance Company" of a Fund that is a separate account shall mean the insurance company that establishes and maintains the separate account and that owns the assets of the separate account.

(xii) Subsidiary. The term "Subsidiary" shall mean an affiliated person of a specified person who is controlled by the specified person directly, or indirectly through one or more intermediaries.

(2) [Reserved.]

(3) General disclosure. Furnish the following information in the proxy statement of a Fund or Funds:

(i) State the name and address of the Fund's investment adviser, principal underwriter, and Administrator.

(ii) When a Fund proxy statement solicits a vote on proposals affecting more than one Fund or class of securities of a Fund (unless the proposal or proposals are the same and affect all Fund or class shareholders), present a summary of all of the proposals in tabular form on one of the first three pages of the proxy statement and indicate which Fund or class shareholders are solicited with respect to each proposal.

(iii) Unless the proxy statement is accompanied by a copy of the Fund's most recent annual report, state prominently in the proxy statement that the Fund will furnish, without charge, a copy of the annual report and the most recent semi-annual report succeeding the annual report, if any, to a shareholder upon request, providing the name, address, and toll-free telephone number of the person to whom such request shall be directed (or, if no toll-free telephone number is provided, a self-addressed postage paid card for requesting the annual report). The Fund should provide a copy of the annual report and the most recent semi-annual report succeeding the annual report, if any, to the requesting shareholder by first class mail, or other means designed to assure prompt delivery, within three business days of the request.

(iv) If the action to be taken would, directly or indirectly, establish a new fee or expense or increase any existing fee or expense to be paid by the Fund or its shareholders, provide a table showing the current and pro forma fees (with the required examples) using the format prescribed in the appropriate registration statement form under the Investment Company Act of 1940 (for open-end management investment companies, Item 3 of Form N-1A (§ 239.15A); for closed-end management investment companies, Item 3 of Form N-2 (§ 239.14); and for separate accounts that offer variable annuity contracts, Item 3 of Form N-3 (§ 239.17a)).

Instructions. 1. Where approval is sought only for a change in asset breakpoints for a pre-existing fee that would not have increased the fee for the previous year (or have the effect of increasing fees or expenses, but for any other reason would not be reflected in a pro forma fee table), describe the likely effect of the change in lieu of providing pro forma fee information.

2. An action would indirectly establish or increase a fee or expense where, for example, the approval of a new investment advisory contract would result in higher custodial or transfer agency fees.

3. The tables should be prepared in a manner designed to facilitate understanding of the impact of any change in fees or expenses.

4. A Fund that offers its shares exclusively to one or more separate accounts and thus is not required to include a fee table in its prospectus (see Item 3 of Form N-1A (§ 239.15A)) should nonetheless prepare a table showing current and pro forma expenses and disclose that the table does not reflect separate account expenses, including sales load.

(v) If action is to be taken with respect to the election of directors or the approval of an advisory contract, describe any purchases or sales of securities of the investment adviser or its Parents, or Subsidiaries of either, since the beginning of the most recently completed fiscal year by any director or any nominee for election as a director of the Fund.

Instructions.

1. Identify the parties, state the consideration, the terms of payment and describe any arrangement or understanding with respect to the composition of the board of directors of the Fund or of the investment adviser, or with respect to the selection of appointment of any person to any office with either such company.

2. Transactions involving securities in an amount not exceeding one percent of the outstanding securities of any class of the investment adviser or any of its Parents or Subsidiaries may be omitted.

(b) Election of Directors. If action is to be taken with respect to the election of directors of a Fund, furnish the following information in the proxy statement in addition to, in the case of business development companies, the information (and in the format) required by Item 7 and Item 8 of this Schedule 14A.

Instructions to introductory text of paragraph (b).

1. Furnish information with respect to a prospective investment adviser to the extent applicable.

2. If the solicitation is made by or on behalf of a person other than the Fund or an investment adviser of the Fund, provide information only as to nominees of the person making the solicitation.

3. When providing information about directors and nominees for election as directors in response to this Item 22(b), furnish information for directors or nominees who are or would be "interested persons" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*) separately from the information for directors or nominees who are not or would not be interested persons of the Fund. For example, when furnishing information in a table, you should provide separate tables (or separate sections of a single table) for directors and nominees who are or would be interested persons and for directors or nominees who are not or would not be interested persons. When furnishing information in narrative form, indicate by heading or otherwise the directors or nominees who are or would be interested persons and the directors or nominees who are not or would not be interested persons.

4. No information need be given about any director whose term of office as a director will not continue after the meeting to which the proxy statement relates.

(1) Provide the information required by the following table for each director, nominee for election as director, Officer of the Fund, person chosen to become an Officer of the Fund, and, if the Fund has an advisory board, member of the board. Explain in a footnote to the table any family relationship between the persons listed.

(1)	(2)	(3)	(4)	(5)	(6)
Name, Address, and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation(s) During Past 5 Years	Number of Portfolios in Fund Complex Overseen by Director or Nominee Director	Other Directorships Held by Director or Nominee for Director

Instructions to paragraph (b)(1).

1. For purposes of this paragraph, the term "family relationship" means any relationship by blood, marriage, or adoption, not more remote than first cousin.

2. No nominee or person chosen to become a director or Officer who has not consented to act as such may be named in response to this Item. In this regard, see Rule 14a-4(d) under the Exchange Act (§ 240.14a-4(d)).

3. If fewer nominees are named than the number fixed by or pursuant to the governing instruments, state the reasons for this procedure and that the proxies cannot be voted for a greater number of persons than the number of nominees named.

4. For each director or nominee for election as director who is or would be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), describe, in a footnote or otherwise, the relationship, events, or transactions by reason of which the director or nominee is or would be an interested person.

5. State the principal business of any company listed under column (4) unless the principal business is implicit in its name.

6. Include in column (5) the total number of separate portfolios that a nominee for election as director would oversee if he were elected.

7. Indicate in column (6) directorships not included in column (5) that are held by a director or nominee for election as director in any company with a class of securities registered pursuant to section 12 of the Exchange Act (*15 U.S.C. 78l*), or subject to the requirements of section 15(d) of the Exchange Act (*15 U.S.C. 78o(d)*), or any company registered as an investment company under the Investment Company Act of 1940, (*15 U.S.C. 80a*), as amended, and name the companies in which the directorships are held. Where the other directorships include directorships overseeing two or more portfolios in the same Fund Complex, identify the Fund Complex and provide the number of portfolios overseen as a director in the Fund Complex rather than listing each portfolio separately.

(2) For each individual listed in column (1) of the table required by paragraph (b)(1) of this Item, except for any director or nominee for election as director who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), describe any positions, including as an officer, employee, director, or general partner, held with affiliated persons or principal underwriters of the Fund.

Instruction to paragraph (b)(2). When an individual holds the same position(s) with two or more registered investment companies that are part of the same Fund Complex, identify the Fund Complex and provide the number of registered investment companies for which the position(s) are held rather than listing each registered investment company separately.

(3) Describe briefly any arrangement or understanding between any director, nominee for election as director, Officer, or person chosen to become an Officer, and any other person(s) (naming the person(s)) pursuant to which he was or is to be selected as a director, nominee, or Officer.

Instruction to paragraph (b)(3). Do not include arrangements or understandings with directors or Officers acting solely in their capacities as such.

(4) Unless disclosed in the table required by paragraph (b)(1) of this Item, describe any positions, including as an officer, employee, director, or general partner, held by any director or nominee for election as director, who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), or Immediate Family Member of the director or nominee, during the past five years, with:

(i) The Fund;

(ii) An investment company, or a person that would be an investment company but for the exclusions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (*15 U.S.C. 80a-3(c)(1)* and *(c)(7)*), having the same investment adviser, principal underwriter, or Sponsoring Insurance Company as the Fund or having an investment adviser, principal underwriter, or Sponsoring Insurance Company that directly or indirectly controls, is controlled by, or is under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund;

(iii) An investment adviser, principal underwriter, Sponsoring Insurance Company, or affiliated person of the Fund; or

(iv) Any person directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund.

Instruction to paragraph (b)(4). When an individual holds the same position(s) with two or more portfolios that are part of the same Fund Complex, identify the Fund Complex and provide the number of portfolios for which the position(s) are held rather than listing each portfolio separately.

(5) For each director or nominee for election as director, state the dollar range of equity securities beneficially owned by the director or nominee as required by the following table:

(i) In the Fund; and

(ii) On an aggregate basis, in any registered investment companies overseen or to be overseen by the director or nominee within the same Family of Investment Companies as the Fund.

(1)	(2)	(3)
Name of Director or Nominee	Dollar Range of Equity Securities in the Fund	Aggregate Dollar Range of Equity Securities in All Funds Overseen or to be Overseen by Direct-

or or Nominee in Family of Investment Companies

Instructions to paragraph (b)(5).

1. Information should be provided as of the most recent practicable date. Specify the valuation date by footnote or otherwise.

2. Determine "beneficial ownership" in accordance with rule 16a-1(a)(2) under the Exchange Act (§ 240.16a-1(a)(2)).

3. If action is to be taken with respect to more than one Fund, disclose in column (2) the dollar range of equity securities beneficially owned by a director or nominee in each such Fund overseen or to be overseen by the director or nominee.

4. In disclosing the dollar range of equity securities beneficially owned by a director or nominee in columns (2) and (3), use the following ranges: none, \$1-\$10,000, \$10,001-\$50,000, \$50,001-\$100,000, or over \$100,000.

(6) For each director or nominee for election as director who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), and his Immediate Family Members, furnish the information required by the following table as to each class of securities owned beneficially or of record in:

(i) An investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund; or

(ii) A person (other than a registered investment company) directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund:

(1)	(2)	(3)	(4)	(5)	(6)
Name of Director or Nominee	Name of Owners and Relationships to Director or Nominee	Company	Title of Class	Value of Securities	Percent of Class

Instructions to paragraph (b)(6).

1. Information should be provided as of the most recent practicable date. Specify the valuation date by footnote or otherwise.

2. An individual is a "beneficial owner" of a security if he is a "beneficial owner" under either rule 13d-3 or rule 16a-1(a)(2) under the Exchange Act (§ § 240.13d-3 or 240.16a-1(a)(2)).

3. Identify the company in which the director, nominee, or Immediate Family Member of the director or nominee owns securities in column (3). When the company is a person directly or indirectly controlling, controlled by, or under

common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company, describe the company's relationship with the investment adviser, principal underwriter, or Sponsoring Insurance Company.

4. Provide the information required by columns (5) and (6) on an aggregate basis for each director (or nominee) and his Immediate Family Members.

(7) Unless disclosed in response to paragraph (b)(6) of this Item, describe any direct or indirect interest, the value of which exceeds \$120,000, of each director or nominee for election as director who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), or Immediate Family Member of the director or nominee, during the past five years, in:

(i) An investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund; or

(ii) A person (other than a registered investment company) directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund.

Instructions to paragraph (b)(7).

1. A director, nominee, or Immediate Family Member has an interest in a company if he is a party to a contract, arrangement, or understanding with respect to any securities of, or interest in, the company.

2. The interest of the director (or nominee) and the interests of his Immediate Family Members should be aggregated in determining whether the value exceeds \$120,000.

(8) Describe briefly any material interest, direct or indirect, of any director or nominee for election as director who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), or Immediate Family Member of the director or nominee, in any transaction, or series of similar transactions, since the beginning of the last two completed fiscal years of the Fund, or in any currently proposed transaction, or series of similar transactions, in which the amount involved exceeds \$120,000 and to which any of the following persons was or is to be a party:

(i) The Fund;

(ii) An Officer of the Fund;

(iii) An investment company, or a person that would be an investment company but for the exclusions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (*15 U.S.C. 80a-3(c)(1)* and *(c)(7)*), having the

same investment adviser, principal underwriter, or Sponsoring Insurance Company as the Fund or having an investment adviser, principal underwriter, or Sponsoring Insurance Company that directly or indirectly controls, is controlled by, or is under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund; An Officer of an investment company, or a person that would be an investment company but for the exclusions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (*15 U.S.C. 80a-3(c)(1) and (c)(7)*), having the same investment adviser, principal underwriter, or Sponsoring Insurance Company as the Fund or having an investment adviser, principal underwriter, or Sponsoring Insurance Company that directly or indirectly controls, is controlled by, or is under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund;

(v) An investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund;

(vi) An Officer of an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund;

(vii) A person directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund; or

(viii) An Officer of a person directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund.

Instructions to paragraph (b)(8). 1. Include the name of each director, nominee, or Immediate Family Member whose interest in any transaction or series of similar transactions is described and the nature of the circumstances by reason of which the interest is required to be described.

2. State the nature of the interest, the approximate dollar amount involved in the transaction, and, where practicable, the approximate dollar amount of the interest.

3. In computing the amount involved in the transaction or series of similar transactions, include all periodic payments in the case of any lease or other agreement providing for periodic payments.

4. Compute the amount of the interest of any director, nominee, or Immediate Family Member of the director or nominee without regard to the amount of profit or loss involved in the transaction(s).

5. As to any transaction involving the purchase or sale of assets, state the cost of the assets to the purchaser and, if acquired by the seller within two years prior to the transaction, the cost to the seller. Describe the method used in determining the purchase or sale price and the name of the person making the determination.

6. If the proxy statement relates to multiple portfolios of a series Fund with different fiscal years, then, in determining the date that is the beginning of the last two completed fiscal years of the Fund, use the earliest date of any series covered by the proxy statement.

7. Disclose indirect, as well as direct, material interests in transactions. A person who has a position or relationship with, or interest in, a company that engages in a transaction with one of the persons listed in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item may have an indirect interest in the transaction by reason of the position, relationship, or

interest. The interest in the transaction, however, will not be deemed "material" within the meaning of paragraph (b)(8) of this Item where the interest of the director, nominee, or Immediate Family Member arises solely from the holding of an equity interest (including a limited partnership interest, but excluding a general partnership interest) or a creditor interest in a company that is a party to the transaction with one of the persons specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item, and the transaction is not material to the company.

8. The materiality of any interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case. The importance of the interest to the person having the interest, the relationship of the parties to the transaction with each other, and the amount involved in the transaction are among the factors to be considered in determining the significance of the information to investors.

9. No information need be given as to any transaction where the interest of the director, nominee, or Immediate Family Member arises solely from the ownership of securities of a person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item and the director, nominee, or Immediate Family Member receives no extra or special benefit not shared on a pro rata basis by all holders of the class of securities.

10. Transactions include loans, lines of credit, and other indebtedness. For indebtedness, indicate the largest aggregate amount of indebtedness outstanding at any time during the period, the nature of the indebtedness and the transaction in which it was incurred, the amount outstanding as of the latest practicable date, and the rate of interest paid or charged.

11. No information need be given as to any routine, retail transaction. For example, the Fund need not disclose that a director has a credit card, bank or brokerage account, residential mortgage, or insurance policy with a person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item unless the director is accorded special treatment.

(9) Describe briefly any direct or indirect relationship, in which the amount involved exceeds \$120,000, of any director or nominee for election as director who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), or Immediate Family Member of the director or nominee, that exists, or has existed at any time since the beginning of the last two completed fiscal years of the Fund, or is currently proposed, with any of the persons specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item. Relationships include:

(i) Payments for property or services to or from any person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item;

(ii) Provision of legal services to any person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item;

(iii) Provision of investment banking services to any person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item, other than as a participating underwriter in a syndicate; and

(iv) Any consulting or other relationship that is substantially similar in nature and scope to the relationships listed in paragraphs (b)(9)(i) through (b)(9)(iii) of this Item.

Instructions to paragraph (b)(9). 1. Include the name of each director, nominee, or Immediate Family Member whose relationship is described and the nature of the circumstances by reason of which the relationship is required to be described.

2. State the nature of the relationship and the amount of business conducted between the director, nominee, or Immediate Family Member and the person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item as a result of the relationship since the beginning of the last two completed fiscal years of the Fund or proposed to be done during the Fund's current fiscal year.

3. In computing the amount involved in a relationship, include all periodic payments in the case of any agreement providing for periodic payments.

4. If the proxy statement relates to multiple portfolios of a series Fund with different fiscal years, then, in determining the date that is the beginning of the last two completed fiscal years of the Fund, use the earliest date of any series covered by the proxy statement.

5. Disclose indirect, as well as direct, relationships. A person who has a position or relationship with, or interest in, a company that has a relationship with one of the persons listed in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item may have an indirect relationship by reason of the position, relationship, or interest.

6. In determining whether the amount involved in a relationship exceeds \$120,000, amounts involved in a relationship of the director (or nominee) should be aggregated with those of his Immediate Family Members.

7. In the case of an indirect interest, identify the company with which a person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item has a relationship; the name of the director, nominee, or Immediate Family Member affiliated with the company and the nature of the affiliation; and the amount of business conducted between the company and the person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item since the beginning of the last two completed fiscal years of the Fund or proposed to be done during the Fund's current fiscal year.

8. In calculating payments for property and services for purposes of paragraph (b)(9)(i) of this Item, the following may be excluded:

A. Payments where the transaction involves the rendering of services as a common contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority; or

B. Payments that arise solely from the ownership of securities of a person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item and no extra or special benefit not shared on a pro rata basis by all holders of the class of securities is received.

9. No information need be given as to any routine, retail relationship. For example, the Fund need not disclose that a director has a credit card, bank or brokerage account, residential mortgage, or insurance policy with a person specified in paragraphs (b)(8)(i) through (b)(8)(viii) of this Item unless the director is accorded special treatment.

(10) If an Officer of an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund, or an Officer of a person directly or indirectly controlling, controlled by, or under common control with an investment adviser, principal underwriter, or Sponsoring Insurance Company of the Fund, serves, or has served since the beginning of the last two completed fiscal years of the Fund, on the board of directors of a company where a director of the Fund or nominee for election as director who is not or would not be an "interested person" of the Fund within the meaning of section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*), or Immediate Family Member of the director or nominee, is, or was since the beginning of the last two completed fiscal years of the Fund, an Officer,

identify:

(i) The company;

(ii) The individual who serves or has served as a director of the company and the period of service as director;

(iii) The investment adviser, principal underwriter, or Sponsoring Insurance Company or person controlling, controlled by, or under common control with the investment adviser, principal underwriter, or Sponsoring Insurance Company where the individual named in paragraph (b)(10)(ii) of this Item holds or held office and the office held; and

(iv) The director of the Fund, nominee for election as director, or Immediate Family Member who is or was an Officer of the company; the office held; and the period of holding the office.

Instruction to paragraph (b)(10). If the proxy statement relates to multiple portfolios of a series Fund with different fiscal years, then, in determining the date that is the beginning of the last two completed fiscal years of the Fund, use the earliest date of any series covered by the proxy statement.

(11) Provide in tabular form, to the extent practicable, the information required by Items 401(f) and (g), 404(a), and 405 of Regulation S-K (§ § 229.401(f) and (g), 229.404(a), and 229.405 of this chapter).

Instruction to paragraph (b)(11).

Information provided under paragraph (b)(8) of this Item 22 is deemed to satisfy the requirements of Item 404(a) of Regulation S-K for information about directors, nominees for election as directors, and Immediate Family Members of directors and nominees, and need not be provided under this paragraph (b)(11).

(12) Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the Fund's business, to which any director or nominee for director or affiliated person of such director or nominee is a party adverse to the Fund or any of its affiliated persons or has a material interest adverse to the Fund or any of its affiliated persons. Include the name of the court where the case is pending, the date instituted, the principal parties, a description of the factual basis alleged to underlie the proceeding, and the relief sought.

(13) In the case of a Fund that is an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), for all directors, and for each of the three highest-paid Officers that have aggregate compensation from the Fund for the most recently completed fiscal year in excess of \$60,000 ("Compensated Persons"):

(i) Furnish the information required by the following table for the last fiscal year:

Compensation Table				
(1)	(2)	(3)	(4)	(5)
Name of Person, Position	Aggregate Compensation From Fund	Pension or Retirement Benefits Accrued as Part of Fund Expenses	Estimated Annual Benefits Upon Retirement	Total Compensation From Fund and Complex Paid to Directors

Instructions to paragraph (b)(13)(i). 1. For column (1), indicate, if necessary, the capacity in which the remuneration is received. For Compensated Persons that are directors of the Fund, compensation is amounts received for service as a director.

2. If the Fund has not completed its first full year since its organization, furnish the information for the current fiscal year, estimating future payments that would be made pursuant to an existing agreement or understanding. Disclose in a footnote to the Compensation Table the period for which the information is furnished.

3. Include in column (2) amounts deferred at the election of the Compensated Person, whether pursuant to a plan established under *Section 401(k) of the Internal Revenue Code (26 U.S.C. 401(k))* or otherwise, for the fiscal year in which earned. Disclose in a footnote to the Compensation Table the total amount of deferred compensation (including interest) payable to or accrued for any Compensated Person.

4. Include in columns (3) and (4) all pension or retirement benefits proposed to be paid under any existing plan in the event of retirement at normal retirement date, directly or indirectly, by the Fund or any of its Subsidiaries, or by other companies in the Fund Complex. Omit column (4) where retirement benefits are not determinable.

5. For any defined benefit or actuarial plan under which benefits are determined primarily by final compensation (or average final compensation) and years of service, provide the information required in column (4) in a separate table showing estimated annual benefits payable upon retirement (including amounts attributable to any defined benefit supplementary or excess pension award plans) in specified compensation and years of service classifications. Also provide the estimated credited years of service for each Compensated Person.

6. Include in column (5) only aggregate compensation paid to a director for service on the board and other boards of investment companies in a Fund Complex specifying the number of such other investment companies.

(ii) Describe briefly the material provisions of any pension, retirement, or other plan or any arrangement other than fee arrangements disclosed in paragraph (b)(13)(i) of this Item pursuant to which Compensated Persons are or may be compensated for any services provided, including amounts paid, if any, to the Compensated Person under any such arrangements during the most recently completed fiscal year. Specifically include the criteria used to determine amounts payable under any plan, the length of service or vesting period required by the plan, the retirement age or other event that gives rise to payments under the plan, and whether the payment of benefits is secured or funded by the Fund.

(14) State whether or not the Fund has a separately designated audit committee established in accordance with section 3(a)(58)(A) of the Act (*15 U.S.C. 78c(a)(58)(A)*). If the entire board of directors is acting as the Fund's audit committee as specified in section 3(a)(58)(B) of the Act (*15 U.S.C. 78c(a)(58)(B)*), so state. If applicable, provide the

disclosure required by § 240.10A-3(d) regarding an exemption from the listing standards for audit committees. Identify the other standing committees of the Fund's board of directors, and provide the following information about each committee, including any separately designated audit committee and any nominating committee:

(i) A concise statement of the functions of the committee;

(ii) The members of the committee and, in the case of a nominating committee, whether or not the members of the committee are "interested persons" of the Fund as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*); and

(iii) The number of committee meetings held during the last fiscal year.

Instruction to paragraph (b)(14): For purposes of Item 22(b)(14), the term "nominating committee" refers not only to nominating committees and committees performing similar functions, but also to groups of directors fulfilling the role of a nominating committee, including the entire board of directors.

(15)

(i) Provide the information (and in the format) required by Items 407(b)(1), (b)(2) and (f) of Regulation S-K (§ 229.407(b)(1), (b)(2) and (f) of this chapter); and

(ii) Provide the following regarding the requirements for the director nomination process:

(A) The information (and in the format) required by Items 407(c)(1) and (c)(2) of Regulation S-K (§ 229.407(c)(1) and (c)(2) of this chapter); and

(B) If the Fund is a listed issuer (as defined in § 240.10A-3 of this chapter) whose securities are listed on a national securities exchange registered pursuant to section 6(a) of the Act (*15 U.S.C. 78f(a)*) or in an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A of the Act (*15 U.S.C. 78o-3(a)*) that has independence requirements for nominating committee members, identify each director that is a member of the nominating committee that is not independent under the independence standards described in this paragraph. In determining whether the nominating committee members are independent, use the Fund's definition of independence that it uses for determining if the members of the nominating committee are independent in compliance with the independence standards applicable for the members of the nominating committee in the listing standards applicable to the Fund. If the Fund does not have independence standards for the nominating committee, use the independence standards for the nominating committee in the listing standards applicable to the Fund.

Instruction to paragraph (b)(15)(ii)(B).

If the national securities exchange or inter-dealer quotation system on which the Fund's securities are listed has exemptions to the independence requirements for nominating committee members upon which the Fund relied, disclose the exemption relied upon and explain the basis for the Fund's conclusion that such exemption is applicable.

(16) In the case of a Fund that is a closed-end investment company:

(i) Provide the information (and in the format) required by Item 407(d)(1), (d)(2) and (d)(3) of Regulation S-K (§ 229.407(d)(1), (d)(2) and (d)(3) of this chapter); and

(ii) Identify each director that is a member of the Fund's audit committee that is not independent under the independence standards described in this paragraph. If the Fund does not have a separately designated audit committee, or committee performing similar functions, the Fund must provide the disclosure with respect to all members of its board of directors.

(A) If the Fund is a listed issuer (as defined in § 240.10A-3 of this chapter) whose securities are listed on a national securities exchange registered pursuant to section 6(a) of the Act (*15 U.S.C. 78f(a)*) or in an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A of the Act (*15 U.S.C. 78o-3(a)*) that has independence requirements for audit committee members, in determining whether the audit committee members are independent, use the Fund's definition of independence that it uses for determining if the members of the audit committee are independent in compliance with the independence standards applicable for the members of the audit committee in the listing standards applicable to the Fund. If the Fund does not have independence standards for the audit committee, use the independence standards for the audit committee in the listing standards applicable to the Fund.

(B) If the Fund is not a listed issuer whose securities are listed on a national securities exchange registered pursuant to section 6(a) of the Act (*15 U.S.C. 78f(a)*) or in an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A of the Act (*15 U.S.C. 78o-3(a)*), in determining whether the audit committee members are independent, use a definition of independence of a national securities exchange registered pursuant to section 6(a) of the Act (*15 U.S.C. 78f(a)*) or an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A of the Act (*15 U.S.C. 78o-3(a)*) which has requirements that a majority of the board of directors be independent and that has been approved by the Commission, and state which definition is used. Whatever such definition the Fund chooses, it must use the same definition with respect to all directors and nominees for director. If the national securities exchange or national securities association whose standards are used has independence standards for the members of the audit committee, use those specific standards.

Instruction to paragraph (b)(16)(ii).

If the national securities exchange or inter-dealer quotation system on which the Fund's securities are listed has exemptions to the independence requirements for nominating committee members upon which the Fund relied, disclose the exemption relied upon and explain the basis for the Fund's conclusion that such exemption is applicable. The same disclosure should be provided if the Fund is not a listed issuer and the national securities exchange or inter-dealer

quotation system selected by the Fund has exemptions that are applicable to the Fund.

(17) In the case of a Fund that is an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), if a director has resigned or declined to stand for re-election to the board of directors since the date of the last annual meeting of security holders because of a disagreement with the registrant on any matter relating to the registrant's operations, policies or practices, and if the director has furnished the registrant with a letter describing such disagreement and requesting that the matter be disclosed, the registrant shall state the date of resignation or declination to stand for re-election and summarize the director's description of the disagreement. If the registrant believes that the description provided by the director is incorrect or incomplete, it may include a brief statement presenting its view of the disagreement.

(c) Approval of investment advisory contract. If action is to be taken with respect to an investment advisory contract, include the following information in the proxy statement.

Instruction. Furnish information with respect to a prospective investment adviser to the extent applicable (including the name and address of the prospective investment adviser).

(1) With respect to the existing investment advisory contract:

(i) State the date of the contract and the date on which it was last submitted to a vote of security holders of the Fund, including the purpose of such submission;

(ii) Briefly describe the terms of the contract, including the rate of compensation of the investment adviser;

(iii) State the aggregate amount of the investment adviser's fee and the amount and purpose of any other material payments by the Fund to the investment adviser, or any affiliated person of the investment adviser, during the last fiscal year of the Fund;

(iv) If any person is acting as an investment adviser of the Fund other than pursuant to a written contract that has been approved by the security holders of the company, identify the person and describe the nature of the services and arrangements;

(v) Describe any action taken with respect to the investment advisory contract since the beginning of the Fund's last fiscal year by the board of directors of the Fund (unless described in response to paragraph (c)(1)(vi)) of this Item 22); and

(vi) If an investment advisory contract was terminated or not renewed for any reason, state the date of such termination or non-renewal, identify the parties involved, and describe the circumstances of such termination or non-renewal.

(2) State the name, address and principal occupation of the principal executive officer and each director or general partner of the investment adviser.

(i) The general partners with the five largest economic interests in the partnership, and, if different, those general partners comprising the management or executive committee of the partnership or exercising similar authority;

(ii) The general partners with significant management responsibilities relating to the fund.

(3) State the names and addresses of all Parents of the investment adviser and show the basis of control of the investment adviser and each Parent by its immediate Parent.

Instructions.

1. If any person named is a corporation, include the percentage of its voting securities owned by its immediate Parent.

2. If any person named is a partnership, name the general partners having the three largest partnership interests (computed by whatever method is appropriate in the particular case).

(4) If the investment adviser is a corporation and if, to the knowledge of the persons making the solicitation or the persons on whose behalf the solicitation is made, any person not named in answer to paragraph (c)(3) of this Item 22 owns, of record or beneficially, ten percent or more of the outstanding voting securities of the investment adviser, indicate that fact and state the name and address of each such person.

(5) Name each officer or director of the Fund who is an officer, employee, director, general partner or shareholder of the investment adviser. As to any officer or director who is not a director or general partner of the investment adviser and who owns securities or has any other material direct or indirect interest in the investment adviser or any other person controlling, controlled by or under common control with the investment adviser, describe the nature of such interest.

(6) Describe briefly and state the approximate amount of, where practicable, any material interest, direct or indirect, of any director of the Fund in any material transactions since the beginning of the most recently completed fiscal year,

or in any material proposed transactions, to which the investment adviser of the Fund, any Parent or Subsidiary of the investment adviser (other than another Fund), or any Subsidiary of the Parent of such entities was or is to be a party.

Instruction. If the investment adviser is a partnership with more than ten general partners, name:

Instructions.

1. Include the name of each person whose interest in any transaction is described and the nature of the relationship by reason of which such interest is required to be described. Where it is not practicable to state the approximate amount of the interest, indicate the approximate amount involved in the transaction.

2. As to any transaction involving the purchase or sale of assets by or to the investment adviser, state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction.

3. If the interest of any person arises from the position of the person as a partner in a partnership, the proportionate interest of such person in transactions to which the partnership is a party need not be set forth, but state the amount involved in the transaction with the partnership.

4. No information need be given in response to this paragraph (c)(6) of Item 22 with respect to any transaction that is not related to the business or operations of the Fund and to which neither the Fund nor any of its Parents or Subsidiaries is a party.

(7) Disclose any financial condition of the investment adviser that is reasonably likely to impair the financial ability of the adviser to fulfil its commitment to the fund under the proposed investment advisory contract.

(8) Describe the nature of the action to be taken on the investment advisory contract and the reasons therefor, the terms of the contract to be acted upon, and, if the action is an amendment to, or a replacement of, an investment advisory contract, the material differences between the current and proposed contract.

(9) If a change in the investment advisory fee is sought, state:

(i) The aggregate amount of the investment adviser's fee during the last year;

(ii) The amount that the adviser would have received had the proposed fee been in effect; and

(iii) The difference between the aggregate amounts stated in response to paragraphs (i) and (ii) of this item (c)(9) as a percentage of the amount stated in response to paragraph (i) of this item (c)(9).

(10) If the investment adviser acts as such with respect to any other Fund having a similar investment objective, identify and state the size of such other Fund and the rate of the investment adviser's compensation. Also indicate for any Fund identified whether the investment adviser has waived, reduced, or otherwise agreed to reduce its compensation under any applicable contract.

Instruction. Furnish the information in response to this paragraph (c)(10) of Item 22 in tabular form.

(11) Discuss in reasonable detail the material factors and the conclusions with respect thereto that form the basis for the recommendation of the board of directors that the shareholders approve an investment advisory contract. Include the following in the discussion:

(i) Factors relating to both the board's selection of the investment adviser and approval of the advisory fee and any other amounts to be paid by the Fund under the contract. This would include, but not be limited to, a discussion of the nature, extent, and quality of the services to be provided by the investment adviser; the investment performance of the Fund and the investment adviser; the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the Fund; the extent to which economies of scale would be realized as the Fund grows; and whether fee levels reflect these economies of scale for the benefit of Fund investors. Also indicate in the discussion whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (e.g., pension funds and other institutional investors). If the board relied upon such comparisons, describe the comparisons that were relied on and how they assisted the board in determining to recommend that the shareholders approve the advisory contract; and

(ii) If applicable, any benefits derived or to be derived by the investment adviser from the relationship with the Fund such as soft dollar arrangements by which brokers provide research to the Fund or its investment adviser in return for allocating Fund brokerage.

Instructions.

1. Conclusory statements or a list of factors will not be considered sufficient disclosure. Relate the factors to the specific circumstances of the Fund and the investment advisory contract for which approval is sought and state how the board evaluated each factor. For example, it is not sufficient to state that the board considered the amount of the investment advisory fee without stating what the board concluded about the amount of the fee and how that affected its determination to recommend approval of the contract.

2. If any factor enumerated in paragraph (c)(11)(i) of this Item 22 is not relevant to the board's evaluation of the investment advisory contract for which approval is sought, note this and explain the reasons why that factor is not relevant.

(12) Describe any arrangement or understanding made in connection with the proposed investment advisory contract with respect to the composition of the board of directors of the Fund or the investment adviser or with respect to the selection or appointment of any person to any office with either such company.

(13) For the most recently completed fiscal year, state:

(i) The aggregate amount of commissions paid to any Affiliated Broker; and

(ii) The percentage of the Fund's aggregate brokerage commissions paid to any such Affiliated Broker.

Instruction. Identify each Affiliated Broker and the relationships that cause the broker to be an Affiliated Broker.

(14) Disclose the amount of any fees paid by the Fund to the investment adviser, its affiliated persons or any affiliated person of such person during the most recent fiscal year for services provided to the Fund (other than under the investment advisory contract or for brokerage commissions). State whether these services will continue to be provided after the investment advisory contract is approved.

(d) Approval of distribution plan. If action is to be taken with respect to a Distribution Plan, include the following information in the proxy statement.

Instruction. Furnish information on a prospective basis to the extent applicable.

(1) Describe the nature of the action to be taken on the Distribution Plan and the reason therefor, the terms of the Distribution Plan to be acted upon, and, if the action is an amendment to, or a replacement of, a Distribution Plan, the material differences between the current and proposed Distribution Plan.

(2) If the Fund has a Distribution Plan in effect:

(i) Provide the date that the Distribution Plan was adopted and the date of the last amendment, if any;

(ii) Disclose the persons to whom payments may be made under the Distribution Plan, the rate of the distribution fee and the purposes for which such fee may be used;

(iii) Disclose the amount of distribution fees paid by the Fund pursuant to the plan during its most recent fiscal year, both in the aggregate and as a percentage of the Fund's average net assets during the period;

(iv) Disclose the name of, and the amount of any payments made under the Distribution Plan by the Fund during its most recent fiscal year to, any person who is an affiliated person of the Fund, its investment adviser, principal underwriter, or Administrator, an affiliated person of such person, or a person that during the most recent fiscal year received 10% or more of the aggregate amount paid under the Distribution Plan by the Fund;

(v) Describe any action taken with respect to the Distribution Plan since the beginning of the Fund's most recent fiscal year by the board of directors of the Fund; and

(vi) If a Distribution Plan was or is to be terminated or not renewed for any reason, state the date or prospective date of such termination or non-renewal, identify the parties involved, and describe the circumstances of such termination or non-renewal.

(3) Describe briefly and state the approximate amount of, where practicable, any material interest, direct or indirect, of any director or nominee for election as a director of the Fund in any material transactions since the beginning of the most recently completed fiscal year, or in any material proposed transactions, to which any person identified in response to Item 22(d)(2)(iv) was or is to be a party.

Instructions.

1. Include the name of each person whose interest in any transaction is described and the nature of the relationship by reason of which such interest is required to be described. Where it is not practicable to state the approximate amount of the interest, indicate the approximate amount involved in the transaction.

2. As to any transaction involving the purchase or sale of assets, state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction.

3. If the interest of any person arises from the position of the person as a partner in a partnership, the proportionate interest of such person in transactions to which the partnership is a party need not be set forth but state the amount involved in the transaction with the partnership.

4. No information need be given in response to this paragraph (d)(3) of Item 22 with respect to any transaction that is not related to the business or operations of the Fund and to which neither the Fund nor any of its Parents or Subsidiaries is a party.

(4) Discuss in reasonable detail the material factors and the conclusions with respect thereto which form the basis for the conclusion of the board of directors that there is a reasonable likelihood that the proposed Distribution Plan (or amendment thereto) will benefit the Fund and its shareholders.

Instruction. Conclusory statements or a list of factors will not be considered sufficient disclosure.

Item 23. Delivery of documents to security holders sharing an address.

If one annual report to security holders, proxy statement, or Notice of Internet Availability of Proxy Materials is being delivered to two or more security holders who share an address in accordance with § 240.14a-3(e)(1), furnish the following information:

(c) Provide the phone number and mailing address to which a security holder can direct a notification to the registrant that the security holder wishes to receive a separate annual report to security holders, proxy statement, or Notice of Internet Availability of Proxy Materials, as applicable, in the future; and

(d) Provide instructions how security holders sharing an address can request delivery of a single copy of annual reports to security holders, proxy statements, or Notices of Internet Availability of Proxy Materials if they are receiving multiple copies of annual reports to security holders, proxy statements, or Notices of Internet Availability of Proxy Materials.

Legislative History

HISTORY: [17 FR 11434, Dec. 18, 1952; 31 FR 213, Jan. 7, 1966; 47 FR 29842, July 9, 1982; 47 FR 55668, Dec. 13, 1982; 48 FR 12697, March 28, 1983; 48 FR 44476, Sept. 29, 1983; 51 FR 42063, Nov. 20, 1986; 51 FR 45576, Dec. 19, 1986; 52 FR 21263, June 5, 1987; 52 FR 21937, June 10, 1987; 52 FR 30146, Aug. 13, 1987; 52 FR 48984, Dec. 29, 1987; 53 FR 9767, March 25, 1988; 53 FR 12931, April 20, 1988; 56 FR 7265, Feb. 21, 1991; 57 FR 36495, Aug. 13, 1992; 57 FR 48158, Oct. 21, 1992; 57 FR 48293, Oct. 22, 1992; 58 FR 14684, March 18, 1993; 58 FR 26383, May 3, 1993; 58 FR 26519, May 4, 1993; 58 FR 63015, Nov. 29, 1993; 59 FR 52696, Oct. 19, 1994; 59 FR 67764, Dec. 30, 1994; 60 FR 32825, June 23, 1995; 61 FR 49960, Sept. 24, 1996; 62 FR 6071, Feb. 10, 1997; 62 FR 36459, July 8, 1997; 63 FR 13944, March 23, 1998; 64 FR 1735, Jan. 12, 1999; 64 FR 27896, May 21, 1999; 64 FR 61457, Nov. 10, 1999; 64 FR 73402, Dec. 30, 1999; 65 FR 65751, Nov. 2, 2000; 65 FR 76087, Dec. 5, 2000; 66 FR 3753, Jan. 16, 2001; 66 FR 13234, March 5, 2001; 67 FR 247, Jan. 2, 2002; 68 FR 6048, Feb. 5, 2003; 68 FR 18821, April 16, 2003; 68 FR 67009, Nov. 28, 2003; 68 FR 69221, Dec. 11, 2003; 69 FR 39807, June 30, 2004; 71 FR 53261, Sept. 8, 2006; 72 FR 4148, 4170, Jan. 29, 2007; 72 FR 42222, 42238, Aug. 1, 2007; 73 FR 934, 977, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1)). Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to

240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 78l, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 78l, 78n and 78g; Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 71 FR 53158, 53261, Sept. 8, 2006, amended this section, effective Nov. 7, 2006. For compliance date information, *see* 71 FR 53158, Sept. 8, 2006; 72 FR 4148, 4170, Jan. 29, 2007, amended this section, effective Mar. 30, 2007. For compliance date information, *see* 72 FR 4148, Jan. 29, 2007; 72 FR 42222, 42238, Aug. 1, 2007, amended Item 4(a)(3), effective Jan. 1, 2008. For compliance date information, *see* 72 FR 42222, Aug. 1,

2007; 73 FR 934, 977, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, *see* 73 FR 934, Jan. 4, 2008.]



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice Appendix E.syn

§ E.syn Synopsis to Appendix E: FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

Sarbanes-Oxley § 302 Corporate Responsibility for Financial Reports [Including Requirements for CEO and CFO Certification in Annual and Quarterly Reports]

Sarbanes-Oxley § 906 Corporate Responsibility for Financial Reports [Including Requirements for, and Criminal Sanctions Relating to, CEO and CFO Certifications in Periodic Reports]

17 CFR § 229.601(b)(31) [Implementing Sarbanes-Oxley § 302]

17 CFR § 229.601 (Item 601) Exhibits.

17 CFR § 240.13a-14 Certification of Disclosure in Annual and Quarterly Reports [Implementing Sarbanes-Oxley § 302].

17 CFR § 240.15d-14 Certification of disclosure in Annual and Quarterly Reports [Implementing Sarbanes-Oxley § 302].

17 CFR § 240.13a-15 Controls and Procedures [Implementing Sarbanes- Oxley §§ 302, 906].

17 CFR § 240.15d-15 Controls and Procedures [Implementing Sarbanes- Oxley §§ 302, 906].

Sarbanes-Oxley § 404 Management Assessment of Internal Controls (15 USC 7262)

17 CFR §§ 210.1-02 Definitions of Terms used in Regulation S-X.

17 CFR § 229.308 (Item 308) Internal Control Over Financial Reporting.

17 CFR § 229.307 (Item 307) Disclosure Controls and Procedures.



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2-E Corporate Governance: Law and Practice Sarbanes-Oxley § 302

§ Oxley 302 Corporate Responsibility for Financial Reports [Including Requirements for CEO and CFO Certification in Annual and Quarterly Reports]

(a) Regulations Required.-- The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78m, 78o(d)*), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that--

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers--

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)--

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) Foreign Reincorporations Have No Effect.-- Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

(c) Deadline.-- The rules required by subsection (a) shall be effective not later than 30 days after the date of enactment of this Act.



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice Sarbanes-Oxley § 906

§ Oxley 906 Corporate Responsibility for Financial Reports [Including Requirements for, and Criminal Sanctions Relating to, CEO and CFO Certifications in Periodic Reports]

(a) In General.-- Chapter 63 of title 18, United States Code, is amended by inserting after section 1349, as created by this Act, the following:

Sec. 1350. Failure of corporate officers to certify financial reports

(a) Certification of Periodic Financial Reports.--Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78m(a) or 78o(d)*) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

(b) Content.--The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78m or 78o(d)*) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

(c) Criminal Penalties.--Whoever--

(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both; or

(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both".

(b) Clerical Amendment.-- The table of sections at the beginning of chapter 63 of title 18, United States Code, is

amended by adding at the end the following: "1350. Failure of corporate officers to certify financial reports".



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 229.601(b)(31)

§ 601(b)(31) [Implementing Sarbanes-Oxley § 302]

(b) Description of exhibits. Set forth below is a description of each document listed in the exhibit tables.

(31)

(i) Rule 13a-14(a)/15d-14(a) Certifications. The certifications required by Rule 13a-14(a) (*17 CFR 240.13a-14(a)*) or Rule 15d-14(a) (*17 CFR 240.15d-14(a)*) exactly as set forth below:

Certificationsn*

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant];

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: _____

[Signature]

[Title]

(ii) Rule 13a-14(d)/15d-14(d) Certifications. If an asset-backed issuer (as defined in § 229.1101), the certifications required by Rule 13a-14(d) (*17 CFR 240.13a-14(d)*) or Rule 15d-14(d) (*17 CFR 240.15d-14(d)*) exactly as set forth below:

Certifications¹

I, [identify the certifying individual], certify that:

1. I have reviewed this report on Form 10-K and all reports on Form 10-D required to be filed in respect of the period covered by this report on Form 10-K of [identify the issuing entity] (the "Exchange Act periodic reports");

2. Based on my knowledge, the Exchange Act periodic reports, taken as a whole, do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, all of the distribution, servicing and other information required to be provided under Form 10-D for the period covered by this report is included in the Exchange Act periodic reports;

4. [I am responsible for reviewing the activities performed by the servicer(s) and based on my knowledge and the compliance review(s) conducted in preparing the servicer compliance statement(s) required in this report under Item 1123 of Regulation AB, and except as disclosed in the Exchange Act periodic reports, the servicer(s) [has/have] fulfilled [its/their] obligations under the servicing agreement(s); and]

[Based on my knowledge and the servicer compliance statement(s) required in this report under Item 1123 of Regulation AB, and except as disclosed in the Exchange Act periodic reports, the servicer(s) [has/have] fulfilled [its/their] obligations under the servicing agreement(s); and]²

5. All of the reports on assessment of compliance with servicing criteria for asset-backed securities and their related attestation reports on assessment of compliance with servicing criteria for asset-backed securities required to be included in this report in accordance with Item 1122 of Regulation AB and Exchange Act Rules 13a-18 and 15d-18 have been included as an exhibit to this report, except as otherwise disclosed in this report. Any material instances of noncompliance described in such reports have been disclosed in this report on Form 10-K.ⁿ³

[In giving the certifications above, I have reasonably relied on information provided to me by the following unaffiliated parties [name of servicer, sub-servicer, co-servicer, depositor or trustee].]ⁿ⁴

Date: _____

[Signature]

[Title]

FOOTNOTES:

(n4)Footnote *. Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

(n5)Footnote 1. With respect to asset-backed issuers, the certification must be signed by either: (1) The senior officer in charge of securitization of the depositor if the depositor is signing the report on Form 10-K; or (2) The senior officer in charge of the servicing function of the servicer if the servicer is signing the report on Form 10-K on behalf of the issuing entity. See Rules 13a-14(e) and 15d-14(e) (§ 240.13a-14(e) and 240.15d-14(e)). If multiple servicers are involved in servicing the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign if a representative of the servicer is to sign the certification. If there is a master servicer and one or more underlying servicers, the references in the certification relate to the master servicer. A natural person must sign the certification in his or her individual capacity, although the title of that person in the organization of which he or she is an officer may be included under the signature.

(n6)Footnote 2. The first version of paragraph 4 is to be used when the servicer is signing the report on behalf of the issuing entity. The second version of paragraph 4 is to be used when the depositor is signing the report.

(n7)Footnote 3. The certification refers to the reports prepared by parties participating in the servicing function that are required to be included as an exhibit to the Form 10-K. See Item 1122 of Regulation AB (§ 229.1122) and Rules 13a-18 and 15d-18 (§ 240.13a-18 and 240.15d-18 of this chapter). If a report that is otherwise required to be included is not attached, disclosure that the report is not included and an associated explanation must be provided in the Form 10-K report.

(n8)Footnote 4. Because the signer of the certification must rely in certain circumstances on information provided by unaffiliated parties outside of the signer's control, this paragraph must be included if the signer is reasonably relying on information that unaffiliated trustees, depositors, servicers, sub-servicers or co-servicers have provided.



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Corporate Governance: Law and Practice

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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 229.601

§ 601 (Item 601) Exhibits.

(a) Exhibits and index required.

(1) Subject to Rule 411(c) (§ 230.411(c) of this chapter) under the Securities Act and Rule 12b-32 (§ 240.12b-32 of this chapter) under the Exchange Act regarding incorporation of exhibits by reference, the exhibits required in the exhibit table shall be filed as indicated, as part of the registration statement or report.

(2) Each registration statement or report shall contain an exhibit index, which shall precede immediately the exhibits filed with such registration statement. For convenient reference, each exhibit shall be listed in the exhibit index according to the number assigned to it in the exhibit table. The exhibit index shall indicate, by handwritten, typed, printed, or other legible form of notation in the manually signed original registration statement or report, the page number in the sequential numbering system where such exhibit can be found. Where exhibits are incorporated by reference, this fact shall be noted in the exhibit index referred to in the preceding sentence. Further, the first page of the manually signed registration statement shall list the page in the filing where the exhibit index is located. For a description of each of the exhibits included in the exhibit table, see paragraph (b) of this section.

(3) This Item applies only to the forms specified in the exhibit table. With regard to forms not listed in that table, reference shall be made to the appropriate form for the specific exhibit filing requirements applicable thereto.

(4) If a material contract or plan of acquisition, reorganization, arrangement, liquidation or succession is executed or becomes effective during the reporting period reflected by a Form 10-Q or Form 10-K, it shall be filed as an exhibit to

the Form 10-Q or Form 10-K filed for the corresponding period. Any amendment or modification to a previously filed exhibit to a Form 10, 10-K or 10-Q document shall be filed as an exhibit to a Form 10-Q and Form 10-K. Such amendment or modification need not be filed where such previously filed exhibit would not be currently required.

Instructions to Item 601:

1. If an exhibit to a registration statement (other than an opinion or consent), filed in preliminary form, has been changed only (A) to insert information as to interest, dividend or conversion rates, redemption or conversion prices, purchase or offering prices, underwriters' or dealers' commissions, names, addresses or participation of underwriters or similar matters, which information appears elsewhere in an amendment to the registration statement or a prospectus filed pursuant to Rule 424(b) under the Securities Act [§ 230.424(b) of this chapter], or (B) to correct typographical errors, insert signatures or make other similar immaterial changes, then, notwithstanding any contrary requirement of any rule or form, the registrant need not refile such exhibit as so amended. Any such incomplete exhibit may not, however, be incorporated by reference in any subsequent filing under any Act administered by the Commission.

2. In any case where two or more indentures, contracts, franchises, or other documents required to be filed as exhibits are substantially identical in all material respects except as to the parties thereto, the dates of execution, or other details, the registrant need file a copy of only one of such documents, with a schedule identifying the other documents omitted and setting forth the material details in which such documents differ from the document a copy of which is filed. The Commission may at any time in its discretion require filing of copies of any documents so omitted.

3. Only copies, rather than originals, need be filed of each exhibit required except as otherwise specifically noted.

4. Electronic filings. Whenever an exhibit is filed in paper pursuant to a hardship exemption (§ § 232.201 and 232.202 of this chapter), the letter "P" (paper) shall be placed next to the exhibit in the list of exhibits required by Item 601(a)(2) of this Rule. Whenever an electronic confirming copy of an exhibit is filed pursuant to a hardship exemption (§ 232.201 or § 232.202(d) of this chapter), the exhibit index should specify where the confirming electronic copy can be located; in addition, the designation "CE" (confirming electronic) should be placed next to the listed exhibit in the exhibit index.

Exhibit Table

Instructions to the Exhibit Table

1. The exhibit table indicates those documents that must be filed as exhibits to the respective forms listed.

2. The "X" designation indicates the documents which are required to be filed with each form even if filed previously with another document, Provided, However, that such previously filed documents may be incorporated by reference to satisfy the filing requirements.

3. The number used in the far left column of the table refers to the appropriate subsection in paragraph (b) where a description of the exhibit can be found. Whenever necessary, alphabetical or numerical subparts may be used.

(b) Description of exhibits.

Set forth below is a description of each document listed in the exhibit tables.

(1) Underwriting agreement. Each underwriting contract or agreement with a principal underwriter pursuant to

which the securities being registered are to be distributed; if the terms of such documents have not been determined, the proposed forms thereof. Such agreement may be filed as an exhibit to a report on Form 8-K (§ 249.308 of this chapter) which is incorporated by reference into a registration statement subsequent to its effectiveness.

(2) Plan of acquisition, reorganization, arrangement, liquidation or succession. Any material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation or arrangement and any amendments thereto described in the statement or report. Schedules (or similar attachments) to these exhibits shall not be filed unless such schedules contain information which is material to an investment decision and which is not otherwise disclosed in the agreement or the disclosure document. The plan filed shall contain a list briefly identifying the contents of all omitted schedules, together with an agreement to furnish supplementally a copy of any omitted schedule to the Commission upon request.

(3)

(i) Articles of incorporation.

The articles of incorporation of the registrant or instruments corresponding thereto as currently in effect and any amendments thereto. Whenever the registrant files an amendment to its articles of incorporation, it must file a complete copy of the articles as amended. However, if such amendment is being reported on Form 8-K (§ 249.308 of this chapter), the registrant is required to file only the text of the amendment as a Form 8-K exhibit. In such case, a complete copy of the articles of incorporation as amended must be filed as an exhibit to the next Securities Act registration statement or periodic report filed by the registrant to which this exhibit requirement applies. Where it is impracticable for the registrant to file a charter amendment authorizing new securities with the appropriate state authority prior to the effective date of the registration statement registering such securities, the registrant may file as an exhibit to the registration statement the form of amendment to be filed with the state authority. In such a case, if material changes are made after the copy is filed, the registrant must also file the changed copy.

(ii) Bylaws.

The bylaws of the registrant or instruments corresponding thereto as currently in effect and any amendments thereto. Whenever the registrant files an amendment to the bylaws, it must file a complete copy of the amended bylaws. However, if such amendment is being reported on Form 8-K (§ 249.308 of this chapter), the registrant is required to file only the text of the amendment as a Form 8-K exhibit. In such case, a complete copy of the bylaws as amended must be filed as an exhibit to the next Securities Act registration statement or periodic report filed by the registrant to which this exhibit requirement applies.

(4) Instruments defining the rights of security holders, including indentures.

(i) All instruments defining the rights of holders of the equity or debt securities being registered including, where applicable, the relevant portion of the articles of incorporation or by-laws of the registrant.

(ii) Except as set forth in paragraph (b)(4)(iii) of this Item for filings on Forms S-1, S-4, S-11, N-14, and F-4 under the Securities Act (§ 239.11, 239.25, 239.18, 239.23 and 239.34 of this chapter) and Forms 10 and 10-K under the Exchange Act (§§ 249.210 and 249.310 of this chapter) all instruments defining the rights of holders of long-term debt of the registrant and its consolidated subsidiaries and for any of its unconsolidated subsidiaries for which financial statements are required to be filed.

(iii) Where the instrument defines the rights of holders of long-term debt of the registrant and its consolidated subsidiaries and for any of its unconsolidated subsidiaries for which financial statements are required to be filed, there need not be filed:

(A) Any instrument with respect to long-term debt not being registered if the total amount of securities authorized thereunder does not exceed 10 percent of the total assets of the registrant and its subsidiaries on a consolidated basis and if there is filed an agreement to furnish a copy of such agreement to the Commission upon request;

(B) Any instrument with respect to any class of securities if appropriate steps to assure the redemption or retirement of such class will be taken prior to or upon delivery by the registrant of the securities being registered; or

(C) Copies of instruments evidencing scrip certificates for fractions of shares.

(iv) If any of the securities being registered are, or will be, issued under an indenture to be qualified under the Trust Indenture Act, the copy of such indenture which is filed as an exhibit shall include or be accompanied by:

(A) A reasonably itemized and informative table of contents; and

(B) A cross-reference sheet showing the location in the indenture of the provisions inserted pursuant to sections 310 through 318(a) inclusive of the Trust Indenture Act of 1939.

(v) With respect to Forms 8-K and 10-Q under the Exchange Act that are filed and that disclose, in the text of the Form 10-Q, the interim financial statements, or the footnotes thereto the creation of a new class of securities or indebtedness or the modification of existing rights of security holders, file all instruments defining the rights of holders of these securities or indebtedness defining the rights of holders of these securities or indebtedness. However, there need not be filed any instrument with respect to long-term debt not being registered which meets the exclusion set forth in paragraph (b)(4)(iii)(A) of this Item.

Instruction 1 to paragraph (b)(4): There need not be filed any instrument which defines the rights of participants (not as security holders) pursuant to an employee benefit plan.

Instruction 2 to paragraph (b)(4) (for electronic filings): If the instrument defining the rights of security holders is in the form of a certificate, the text appearing on the certificate shall be reproduced in an electronic filing together with a description of any other graphic and image material appearing on the certificate, as provided in Rule 304 of Regulation S-T (§ 232.304 of this chapter).

(5) Opinion re legality.

(i) An opinion of counsel as to the legality of the securities being registered, indicating whether they will, when sold, be legally issued, fully paid and non-assessable, and, if debt securities, whether they will be binding obligations of the registrant.

(ii) If the securities being registered are issued under a plan and the plan is subject to the requirements of ERISA furnish either:

(A) An opinion of counsel which confirms compliance of the provisions of the written documents constituting the plan with the requirements of ERISA pertaining to such provisions; or

(B) A copy of the Internal Revenue Service determination letter that the plan is qualified under *section 401 of the Internal Revenue Code*; or

(iii) If the securities being registered are issued under a plan which is subject to the requirements of ERISA and the plan has been amended subsequent to the filing of paragraph (b)(5)(ii)(A) or (B) above, furnish either:

(A) An opinion of counsel which confirms compliance of the amended provisions of the plan with the requirements of ERISA pertaining to such provisions; or

(B) A copy of the Internal Revenue Service determination letter that the amended plan is qualified under *section 401 of the Internal Revenue Code*.

Note: Attention is directed to Item 8 of Form S-8 for exemptions to this exhibit requirement applicable to that Form.

(6) [Reserved.]

(7) Correspondence from an independent accountant regarding non-reliance on a previously issued audit report or completed interim review. Any written notice from the registrant's current or previously engaged independent accountant that the independent accountant is withdrawing a previously issued audit report or that a previously issued audit report or completed interim review, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (part 210 of this chapter), should no longer be relied upon. In addition, any letter, pursuant to Item 4.02(c) of Form 8-K (§ 249.308 of this chapter), from the independent accountant to the Commission stating whether the independent accountant agrees with the statements made by the registrant describing the events giving rise to the notice.

(8) Opinion re tax matters.

For filings on Form S-11 under the Securities Act (§ 239.18) or those to which Securities Act Industry Guide 5 applies, an opinion of counsel or of an independent public or certified public accountant or, in lieu thereof, a revenue ruling from the Internal Revenue Service, supporting the tax matters and consequences to the shareholders as described in the filing when such tax matters are material to the transaction for which the registration statement is being filed. This exhibit otherwise need only be filed with the other applicable registration forms where the tax consequences are material to an investor and a representation as to tax consequences is set forth in the filing. If a tax opinion is set forth in full in the filing, an indication that such is the case may be made in lieu of filing the otherwise required exhibit. Such tax opinions may be conditioned or may be qualified, so long as such conditions and qualifications are adequately described in the filing.

(9) Voting trust agreement.

Any voting trust agreements and amendments thereto.

(10) Material contracts.

(i) Every contract not made in the ordinary course of business which is material to the registrant and is to be performed in whole or in part at or after the filing of the registration statement or report or was entered into not more than two years before such filing. Only contracts need be filed as to which the registrant or subsidiary of the registrant is a party or has succeeded to a party by assumption or assignment or in which the registrant or such subsidiary has a beneficial interest.

(ii) If the contract is such as ordinarily accompanies the kind of business conducted by the registrant and its subsidiaries, it will be deemed to have been made in the ordinary course of business and need not be filed unless it falls within one or more of the following categories, in which case it shall be filed except where immaterial in amount or

significance:

(A) Any contract to which directors, officers, promoters, voting trustees, security holders named in the registration statement or report, or underwriters are parties other than contracts involving only the purchase or sale of current assets having a determinable market price, at such market price;

(B) Any contract upon which the registrant's business is substantially dependent, as in the case of continuing contracts to sell the major part of registrant's products or services or to purchase the major part of registrant's requirements of goods, services or raw materials or any franchise or license or other agreement to use a patent, formula, trade secret, process or trade name upon which registrant's business depends to a material extent;

(C) Any contract calling for the acquisition or sale of any property, plant or equipment for a consideration exceeding 15 percent of such fixed assets of the registrant on a consolidated basis; or

(D) Any material lease under which a part of the property described in the registration statement or report is held by the registrant.

(iii)

(A) Any management contract or any compensatory plan, contract or arrangement, including but not limited to plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit sharing (or if not set forth in any formal document, a written description thereof) in which any director or any of the named executive officers of the registrant, as defined by Item 402(a)(3) (§ 229.402(a)(3)), participates shall be deemed material and shall be filed; and any other management contract or any other compensatory plan, contract, or arrangement in which any other executive officer of the registrant participates shall be filed unless immaterial in amount or significance.

(B) Any compensatory plan, contract or arrangement adopted without the approval of security holders pursuant to which equity may be awarded, including, but not limited to, options, warrants or rights (or if not set forth in any formal document, a written description thereof), in which any employee (whether or not an executive officer of the registrant) participates shall be filed unless immaterial in amount or significance. A compensation plan assumed by a registrant in connection with a merger, consolidation or other acquisition transaction pursuant to which the registrant may make further grants or awards of its equity securities shall be considered a compensation plan of the registrant for purposes of the preceding sentence.

(C) Notwithstanding paragraph (b)(10)(iii)(A) above, the following management contracts or compensatory plans, contracts or arrangements need not be filed:

(1) Ordinary purchase and sales agency agreements.

(2) Agreements with managers of stores in a chain organization or similar organization.

(3) Contracts providing for labor or salesmen's bonuses or payments to a class of security holders, as such.

(4) Any compensatory plan, contract or arrangement which pursuant to its terms is available to employees, officers or directors generally and which in operation provides for the same method of allocation of benefits between management and nonmanagement participants.

(5) Any compensatory plan, contract or arrangement if the registrant is a foreign private issuer that furnishes compensatory information under Item 402(a)(1) (§ 229.402(a)(1)) and the public filing of the plan, contract or arrangement, or portion thereof, is not required in the registrant's home country and is not otherwise publicly disclosed by the registrant.

(6) Any compensatory plan, contract, or arrangement if the registrant is a wholly owned subsidiary of a company that has a class of securities registered pursuant to section 12 or files reports pursuant to section 15(d) of the Exchange Act and is filing a report on Form 10-K or registering debt instruments or preferred stock that are not voting securities on Form S-1.

Instruction 1 to paragraph (b)(10): With the exception of management contracts, in order to comply with paragraph (iii) above, registrants need only file copies of the various compensatory plans and need not file each individual director's or executive officer's personal agreement under the plans unless there are particular provisions in such personal agreements whose disclosure in an exhibit is necessary to an investor's understanding of that individual's compensation under the plan.

Instruction 2 to paragraph (b)(10): If a material contract is executed or becomes effective during the reporting period reflected by a Form 10-Q or Form 10-K, it shall be filed as an exhibit to the Form 10-Q or Form 10-K filed for the corresponding period. See paragraph (a)(4) of this Item. With respect to quarterly reports on Form 10-Q, only those contracts executed or becoming effective during the most recent period reflected in the report shall be filed.

(11) Statement re computation of per share earnings.

A statement setting forth in reasonable detail the computation of per share earnings, unless the computation can be clearly determined from the material contained in the registration statement or report. The information with respect to the computation of per share earnings on both primary and fully diluted basis, presented by exhibit or otherwise, must be furnished even though the amounts of per share earnings on the fully diluted bases are not required to be presented in the income statement under the provisions of Accounting Principles Board Opinion No. 15. That Opinion provides that

any reduction of less than 3% need not be considered as dilution (see footnote to paragraph 14 of the Opinion) and that a computation on the fully diluted basis which results in improvement of earnings per share not be taken into account (see paragraph 40 of the Opinion).

(12) Statements re computation of ratios.

A statement setting forth in reasonable detail the computation of any ratio of earnings to fixed charges, any ratio of earnings to combined fixed charges and preferred stock dividends or any other ratios which appear in the registration statement or report. See Item 503(d) of Regulation S-K (§ 229.503(d)).

(13) Annual report to security holders, Form 10-Q or quarterly report to security holders.

(i) The registrant's annual report to security holders for its last fiscal year, its Form 10-Q (if specifically incorporated by reference in the prospectus) or its quarterly report to security holders, if all or a portion thereof is incorporated by reference in the filing. Such report, except for those portions thereof that are expressly incorporated by reference in the filing, is to be furnished for the information of the Commission and is not to be deemed "filed" as part of the filing. If the financial statements in the report have been incorporated by reference in the filing, the accountant's certificate shall be manually signed in one copy. (*See* Rule 411(b) (§ 230.411(b) of this chapter).

(ii) Electronic filings. If all, or any portion, of the annual or quarterly report to security holders is incorporated by reference into any electronic filing, all, or such portion of the annual or quarterly report to security holders so incorporated, shall be filed in electronic format as an exhibit to the filing.

(14) Code of ethics.

Any code of ethics, or amendment thereto, that is the subject of the disclosure required by Item 406 of Regulation S-K (§ 229.406) or Item 10 of Form 8-K (§ 249.308 of this chapter), to the extent that the registrant intends to satisfy the Item 406 or Item 10 requirements through filing of an exhibit.

(15) Letter re unaudited interim financial information.

A letter, where applicable, from the independent accountant that acknowledges awareness of the use in a registration statement of a report on unaudited interim financial information that pursuant to Rule 436(c) under the Securities Act (§ 230.436(c) of this chapter) is not considered a part of a registration statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of sections 7 and 11 of that Act. Such letter may be filed with the registration statement, an amendment thereto, or a report on Form 10-Q which is incorporated by reference into the registration statement.

(16) Letter re change in certifying accountant.

A letter from the registrant's former independent accountant regarding its concurrence or disagreement with the statements made by the registrant in the current report concerning the resignation or dismissal as the registrant's principal accountant.

(17) Correspondence on departure of director.

Any written correspondence from a former director concerning the circumstances surrounding the former director's retirement, resignation, refusal to stand for re-election or removal, including any letter from the former director to the registrant stating whether the former director agrees with statements made by the registrant describing the former director's departure.

(18) Letter re change in accounting principles.

Unless previously filed, a letter from the registrant's independent accountant indicating whether any change in accounting principles or practices followed by the registrant, or any change in the method of applying any such accounting principles or practices, which affected the financial statements being filed with the Commission in the report or which is reasonably certain to affect the financial statements of future fiscal years is to an alternative principle which in his judgment is preferable under the circumstances. No such letter need be filed when such change is made in response to a standard adopted by the Financial Accounting Standards Board that creates a new accounting principle, that expresses a preference for an accounting principle, or that rejects a specific accounting principle.

(19) Report furnished to security holders.

If the registrant makes available to its security holders or otherwise publishes, within the period prescribed for filing the report, a document or statement containing information meeting some or all of the requirements of Part I of Form 10-Q, the information called for may be incorporated by reference to such published document or statement, provided copies thereof are included as an exhibit to the registration statement or to Part I of the Form 10-Q report.

(20) Other documents or statements to security holders.

If the registrant makes available to its stockholders or otherwise publishes, within the period prescribed for filing the report, a document or statement containing information meeting some or all of the requirements of this form the information called for may be incorporated by reference to such published document or statement provided copies thereof are filed as an exhibit to the report on this form.

(21) Subsidiaries of the registrant.

- (i) List all subsidiaries of the registrant, the state or other jurisdiction of incorporation or organization of each, and

the names under which such subsidiaries do business. This list may be incorporated by reference from a document which includes a complete and accurate list.

(ii) The names of particular subsidiaries may be omitted if the unnamed subsidiaries, considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary as of the end of the year covered by this report. (See the definition of "significant subsidiary" in Rule 1-02(w) (*17 CFR 210.1-02(w)*) of Regulation S-X.) The names of consolidated wholly-owned multiple subsidiaries carrying on the same line of business, such as chain stores or small loan companies, may be omitted, provided the name of the immediate parent, the line of business, the number of omitted subsidiaries operating in the United States and the number operating in foreign countries are given. This instruction shall not apply, however, to banks, insurance companies, savings and loan associations or to any subsidiary subject to regulation by another Federal agency.

(22) Published report regarding matters submitted to vote of security holders. Published reports containing all of the information called for by Item 4 of Part II of Form 10-Q or Item 4 of Part I of Form 10-K that is referred to therein in lieu of providing disclosure in Form 10-Q or 10-K, that are required to be filed as exhibits by Rule 12b-23(a)(3) under the Exchange Act (§ 240.12b-23(a)(3) of this chapter).

(23) Consents of experts and counsel--

(i) Securities Act filings. All written consents required to be filed shall be dated and manually signed. Where the consent of an expert or counsel is contained in his report or opinion or elsewhere in the registration statement or document filed therewith, a reference shall be made in the index to the report, the part of the registration statement or document or opinion, containing the consent.

(ii) Exchange Act reports. Where the filing of a written consent is required with respect to material incorporated by reference in a previously filed registration statement under the Securities Act, such consent may be filed as exhibit to the material incorporated by reference. Such consents shall be dated and manually signed.

(24) Power of attorney.

If any name is signed to the registration statement or report pursuant to a power of attorney, manually signed copies of such power of attorney shall be filed. Where the power of attorney is contained elsewhere in the registration statement or documents filed therewith a reference shall be made in the index to the part of the registration statement or document containing such power of attorney. In addition, if the name of any officer signing on behalf of the registrant is signed pursuant to a power of attorney, certified copies of a resolution of the registrant's board of directors authorizing such signature shall also be filed. A power of attorney that is filed with the Commission shall relate to a specific filing or an amendment thereto, provided, however, that a power of attorney relating to a registration statement under the Securities Act or an amendment thereto also may relate to any registration statement for the same offering that is to be effective upon filing pursuant to Rule 462(b) under the Securities Act (§ 230.462(b) of this chapter). A power of

attorney that confers general authority shall not be filed with the Commission.

(25) Statement of eligibility of trustee.

(i) A statement of eligibility and qualification of each person designated to act as trustee under an indenture to be qualified under the Trust Indenture Act of 1939. Such statement of eligibility shall be bound separately from the other exhibits.

(ii) Electronic filings. The requirement to bind separately the statement of eligibility and qualification of each person designated to act as a trustee under the Trust Indenture Act of 1939 from other exhibits shall not apply to statements submitted in electronic format. Rather, such statements must be submitted as exhibits in the same electronic submission as the registration statement to which they relate, or in an amendment thereto, except that electronic filers that rely on Trust Indenture Act Section 305(b)(2) for determining the eligibility of the trustee under indentures for securities to be issued, offered or sold on a delayed basis by or on behalf of the registrant shall file such statements separately in the manner prescribed by § 260.5b-1 through § 260.5b-3 of this chapter and by the EDGAR Filer Manual.

(26) Invitations for competitive bids.

If the registration statement covers securities to be offered at competitive bidding, any form of communication which is an invitation for competitive bid which will be sent or given to any person shall be filed.

(27) to (30) [Reserved.]

(31)

(i) Rule 13a-14(a)/15d-14(a) Certifications. The certifications required by Rule 13a-14(a) (*17 CFR 240.13a-14(a)*) or Rule 15d-14(a) (*17 CFR 240.15d-14(a)*) exactly as set forth below:

Certifications*

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant];
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were

made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize

and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: _____

[Signature]

[Title]

*Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

(ii) Rule 13a-14(d)/15d-14(d) Certifications. If an asset-backed issuer (as defined in 229.1101), the certifications required by Rule 13a-14(d) (*17 CFR 240.13a-14(d)*) or Rule 15d-14(d) (*17 CFR 240.15d-14(d)*) exactly as set forth below:

Certifications¹

I, [identify the certifying individual], certify that:

1. I have reviewed this report on Form 10-K and all reports on Form 10-D required to be filed in respect of the period covered by this report on Form 10-K of [identify the issuing entity] (the "Exchange Act periodic reports");

2. Based on my knowledge, the Exchange Act periodic reports, taken as a whole, do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, all of the distribution, servicing and other information required to be provided under Form 10-D for the period covered by this report is included in the Exchange Act periodic reports;

4. [I am responsible for reviewing the activities performed by the servicer(s) and based on my knowledge and the compliance review(s) conducted in preparing the servicer compliance statement(s) required in this report under Item 1123 of Regulation AB, and except as disclosed in the Exchange Act periodic reports, the servicer(s) [has/have] fulfilled

[its/their] obligations under the servicing agreement(s) in all material respects; and]

[Based on my knowledge and the servicer compliance statement(s) required in this report under Item 1123 of Regulation AB, and except as disclosed in the Exchange Act periodic reports, the servicer(s) [has/have] fulfilled [its/their] obligations under the servicing agreement(s) in all material respects; and]n2

5. All of the reports on assessment of compliance with servicing criteria for asset-backed securities and their related attestation reports on assessment of compliance with servicing criteria for asset-backed securities required to be included in this report in accordance with Item 1122 of Regulation AB and Exchange Act Rules 13a-18 and 15d-18 have been included as an exhibit to this report, except as otherwise disclosed in this report. Any material instances of noncompliance described in such reports have been disclosed in this report on Form 10-K. n3

[In giving the certifications above, I have reasonably relied on information provided to me by the following unaffiliated parties [name of servicer, sub-servicer, co-servicer, depositor or trustee].]n4

Date: _____

[Signature]

[Title]

(32) Section 1350 Certifications.

(i) The certifications required by Rule 13a-14(b) (*17 CFR 240.13a-14(b)*) or Rule 15d-14(b) (*17 CFR 240.15d-14(b)*) and Section 1350 of Chapter 63 of Title 18 of the United States Code (*18 U.S.C. 1350*).

(ii) A certification furnished pursuant to this item will not be deemed "filed" for purposes of Section 18 of the Exchange Act (*15 U.S.C. 78r*), or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

(33) Report on assessment of compliance with servicing criteria for asset-backed securities. Each report on assessment of compliance with servicing criteria required by § 229.1122(a).

(34) Attestation report on assessment of compliance with servicing criteria for asset-backed securities. Each

attestation report on assessment of compliance with servicing criteria for asset-backed securities required by § 229.1122(b).

(35) Servicer compliance statement. Each servicer compliance statement required by § 229.1123.

(36) to (98) [Reserved.]

(99) Additional exhibits.

(i) Any additional exhibits which the registrant may wish to file shall be so marked as to indicate clearly the subject matters to which they refer.

(ii) Any document (except for an exhibit) or part thereof which is incorporated by reference in the filing and is not otherwise required to be filed by this Item or is not a Commission filed document incorporated by reference in a Securities Act registration statement.

(iii) If pursuant to Section 11(a) of the Securities Act (*15 U.S.C. 77k(a)*) an issuer makes generally available to its security holders an earnings statement covering a period of at least 12 months beginning after the effective date of the registration statement, and if such earnings statement is made available by "other methods" than those specified in paragraphs (a) or (b) of § 230.158 of this chapter, it must be filed as an exhibit to the Form 10-Q or the Form 10-K, as appropriate, covering the period in which the earnings statement was released.

(100) XBRL-Related Documents. An electronic filer that participates in the voluntary XBRL (eXtensible Business Reporting Language) program may submit XBRL-Related Documents (§ 232.11 of this chapter) in electronic format as an exhibit to: the filing to which they relate; an amendment to such filing; or a Form 8-K (§ 249.308 of this chapter) that references such filing, if the Form 8-K is submitted no earlier than date of that filing.

(c) Smaller reporting companies. A smaller reporting company need not provide the disclosure required in paragraph (b)(12) of this Item, Statements re computation of ratios.

Legislative History

HISTORY: 47 FR 11401, March 16, 1982; as amended at 47 FR 25127, June 10, 1982; 47 FR 54769, Dec. 6, 1982; 48 FR 19874, May 3, 1983; 48 FR 44475, Sept. 29, 1983; 49 FR 47599, Dec. 6, 1984; 50 FR 19000, May 6, 1985; 50 FR 49534, Dec. 3, 1985; 51 FR 42057, Nov. 20, 1986; 52 FR 21260, June 5, 1987; 55 FR 23922, June 13,

1990; 56 FR 30054, July 1, 1991; 57 FR 48158, Oct. 21, 1992; 58 FR 14665, 14857, March 18, 1993; 58 FR 17327, April 2, 1993; 58 FR 27471, May 10, 1993; 59 FR 36260, July 15, 1994; 59 FR 65637, Dec. 20, 1994; 59 FR 67760, Dec. 30, 1994; 60 FR 26615, May 17, 1995; 61 FR 24654, May 15, 1996; 61 FR 30401, June 14, 1996; 62 FR 36456, July 8, 1997; 64 FR 53909, Oct. 5, 1999; 65 FR 24799, April 27, 2000; 67 FR 247, Jan. 2, 2002; 68 FR 5128, Jan. 31, 2003; 68 FR 36663, June 18, 2003; 69 FR 9722, March 1, 2004; 69 FR 15615, March 25, 2004; 70 FR 1594, Jan. 7, 2005; 70 FR 6568, Feb. 8, 2005; 70 FR 11528, March 8, 2005; 70 FR 72373, Dec. 5, 2005; 71 FR 53259, Sept. 8, 2006; 73 FR 943, 965, Jan. 4, 2008.

AUTHORITY: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38, 80av39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted. Section 229.303 is also issued under secs. 3(a) and 401(a), Pub.L. No. 107-204, 116 Stat. 745. Section 229.307 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 229.401 is also issued under secs. 3(a) and 407, Pub. L. No. 107-204, 116 Stat. 745. Section 229.406 is also issued under secs. 3(a) and 406, Pub. L. No. 107-204, 116 Stat. 745. Section 229.601 is also issued under secs. 3(a) and 406, Pub. L. No. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 71 FR 53158, 53259, Sept. 8, 2006, revised paragraph (b)(10)(iii)(C)(5), effective Nov. 7, 2006. For compliance date information, see 71 FR 53158, Sept. 8, 2006; 73 FR 934, 965, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, see 73 FR 934, Jan. 4, 2008.]

FOOTNOTES:

(n9)Footnote 1. With respect to asset-backed issuers, the certification must be signed by either: (1) The senior officer in charge of securitization of the depositor if the depositor is signing the report on Form 10-K; or (2) The senior officer in charge of the servicing function of the servicer if the servicer is signing the report on Form 10-K on behalf of the issuing entity. See Rules 13a-14(e) and 15d-14(e) (240.13a-14(e) and 240.15d-14(e)). If multiple servicers are involved in servicing the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign if a representative of the servicer is to sign the certification. If there is a master servicer and one or more underlying servicers, the references in the certification relate to the master servicer. A natural person must sign the certification in his or her individual capacity, although the title of that person in the organization of which he or she is an officer may be included under the signature.

(n10)Footnote 2. The first version of paragraph 4 is to be used when the servicer is signing the report on behalf of the issuing entity. The second version of paragraph 4 is to be used when the depositor is signing the report.

(n11)Footnote 3. The certification refers to the reports prepared by parties participating in the servicing function that are required to be included as an exhibit to the Form 10-K. See Item 1122 of Regulation AB (229.1122) and Rules 13a-18 and 15d-18 (240.13a-18 and 240.15d-18 of this chapter). If a report that is otherwise required to be included is not attached, disclosure that the report is not included and an associated explanation must be provided in the Form 10-K report.

(n12)Footnote 4. Because the signer of the certification must rely in certain circumstances on information provided by unaffiliated parties outside of the signer's control, this paragraph must be included if the signer is reasonably relying on information that unaffiliated trustees, depositors, servicers, sub-servicers or co-servicers have provided.



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Corporate Governance: Law and Practice

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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 240.13a-14

§ 14 Certification of Disclosure in Annual and Quarterly Reports [Implementing Sarbanes-Oxley § 302].

(a) Each report, including transition reports, filed on Form 10-Q, Form 10-K, Form 20-F or Form 40-F (§§ 249.308a, 249.310, 249.220f or 249.240f of this chapter) under Section 13(a) of the Act (*15 U.S.C. 78m(a)*) other than a report filed by an Asset-Backed Issuer (as defined in § 229.1101 of this chapter) or a report on Form 20-F filed under § 240.13a-19, must include certifications in the form specified in the applicable exhibit filing requirements of such report and such certifications must be filed as an exhibit to such report. Each principal executive and principal financial officer of the issuer, or persons performing similar functions, at the time of filing of the report must sign a certification. The principal executive and principal financial officers of an issuer may omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the issuer until the issuer becomes subject to the internal control over financial reporting requirements in § 240.13a-15 or 240.15d-15).

(b) Each periodic report containing financial statements filed by an issuer pursuant to section 13(a) of the Act (*15 U.S.C. 78m(a)*) must be accompanied by the certifications required by Section 1350 of Chapter 63 of Title 18 of the United States Code (*18 U.S.C. 1350*) and such certifications must be furnished as an exhibit to such report as specified in the applicable exhibit requirements for such report. Each principal executive and principal financial officer of the issuer (or equivalent thereof) must sign a certification. This requirement may be satisfied by a single certification signed by an issuer's principal executive and principal financial officers.

(c) A person required to provide a certification specified in paragraph (a), (b) or (d) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(d) Each annual report and transition report filed on Form 10-K (§ 249.310 of this chapter) by an asset-backed issuer under section 13(a) of the Act (*15 U.S.C. 78m(a)*) must include a certification in the form specified in the applicable exhibit filing requirements of such report and such certification must be filed as an exhibit to such report. Terms used in

paragraphs (d) and (e) of this section have the same meaning as in Item 1101 of Regulation AB (§ 229.1101 of this chapter).

(e) With respect to asset-backed issuers, the certification required by paragraph (d) of this section must be signed by either:

(1) The senior officer in charge of securitization of the depositor if the depositor is signing the report; or

(2) The senior officer in charge of the servicing function of the servicer if the servicer is signing the report on behalf of the issuing entity. If multiple servicers are involved in servicing the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign if a representative of the servicer is to sign the report on behalf of the issuing entity.

(f) The certification requirements of this section do not apply to XBRL-Related Documents, as defined in § 232.11 of this chapter.

Legislative History

HISTORY: [67 FR 57276, 57288, Sept. 9, 2002; 68 FR 36636, 36665, June 18, 2003; 69 FR 9722, Mar. 1, 2004; 70 FR 1506, 1621, Jan. 7, 2005; 70 FR 6556, 6572, Feb. 8, 2005; 70 FR 11528, Mar. 8, 2005; 70 FR 42234, 42247, July 21, 2005; 70 FR 56825, Sept. 29, 2005; 71 FR 76580, 76596, Dec. 21, 2006; 73 FR 934, 976, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section

240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 781, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 781, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 71 FR 76580, 76596, Dec. 21, 2006, amended paragraph (a), effective Feb.

20, 2007. For compliance date information, see 71 FR 76580, 76581, Dec. 21, 2006; 73 FR 934, 976, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, see 73 FR 934, Jan. 4, 2008].



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 240.15d-14

§ 14 Certification of disclosure in Annual and Quarterly Reports [Implementing Sarbanes-Oxley § 302].

(a) Each report, including transition reports, filed on Form 10-Q, Form 10-K, Form 20-F or Form 40-F (§ 249.308a, 249.310, 249.220f or 249.240f of this chapter) under section 15(d) of the Act (*15 U.S.C. 78o(d)*), other than a report filed by an Asset-Backed Issuer (as defined in § 229.1101 of this chapter) or a report on Form 20-F filed under § 240.15d-19, must include certifications in the form specified in the applicable exhibit filing requirements of such report, and such certifications must be filed as an exhibit to such report. Each principal executive and principal financial officer of the issuer, or persons performing similar functions, at the time of filing of the report must sign a certification. The principal executive and principal financial officers of an issuer may omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the issuer until the issuer becomes subject to the internal control over financial reporting requirements in § 240.13a-15 or 240.15d-15).

(b) Each periodic report containing financial statements filed by an issuer pursuant to section 15(d) of the Act (*15 U.S.C. 78o(d)*) must be accompanied by the certifications required by Section 1350 of Chapter 63 of Title 18 of the United States Code (*18 U.S.C. 1350*) and such certifications must be furnished as an exhibit to such report as specified in the applicable exhibit requirements for such report. Each principal executive and principal financial officer of the issuer (or equivalent thereof) must sign a certification. This requirement may be satisfied by a single certification signed by an issuer's principal executive and principal financial officers.

(c) A person required to provide a certification specified in paragraph (a), (b) or (d) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(d) Each annual report and transition report filed on Form 10-K (§ 249.310 of this chapter) by an asset-backed issuer under section 15(d) of the Act (*15 U.S.C. 78o(d)*) must include a certification in the form specified in the applicable exhibit filing requirements of such report and such certification must be filed as an exhibit to such report. Terms used in

paragraphs (d) and (e) of this section have the same meaning as in Item 1101 of Regulation AB (§ 229.1101 of this chapter).

(e) With respect to asset-backed issuers, the certification required by paragraph (d) of this section must be signed by either:

(1) The senior officer in charge of securitization of the depositor if the depositor is signing the report; or

(2) The senior officer in charge of the servicing function of the servicer if the servicer is signing the report on behalf of the issuing entity. If multiple servicers are involved in servicing the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign if a representative of the servicer is to sign the report on behalf of the issuing entity.

(f) The certification requirements of this section do not apply to XBRL-Related Documents, as defined in § 232.11 of this chapter.

Legislative History

HISTORY: [67 FR 57288, Sept. 9, 2002; 68 FR 36665, June 18, 2003; 69 FR 9722, March 1, 2004; 70 FR 1621, Jan. 7, 2005; 70 FR 6572, Feb. 8, 2005; 70 FR 11528, March 8, 2005; 70 FR 42247, July 21, 2005; 71 FR 76596, Dec. 21, 2006; 73 FR 934, 976, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section

240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 781, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 781, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 71 FR 76580, 76596, Dec. 21, 2006, amended paragraph (a), effective Feb.

20, 2007. For compliance date information, *see* 71 FR 76580, 76581, Dec. 21, 2006; 73 FR 934, 976, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, *see* 73 FR 934, Jan. 4, 2008.]



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Corporate Governance: Law and Practice

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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 240.13a-15

§ 15 Controls and Procedures [Implementing Sarbanes- Oxley §§ 302, 906].

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.

(d) The management of each such issuer that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

(e) For purposes of this section, the term disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (*15 U.S.C. 78a et seq.*) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls

and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(f) The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

Legislative History

HISTORY: [67 FR 57276, 57289, Sept. 9, 2002; 68 FR 5348, 5364, Feb. 3, 2003; 68 FR 36636, 36666, June 18, 2003; 69 FR 9722, Mar. 1, 2004; 70 FR 1506, 1621, Jan. 7, 2005; 70 FR 11528, Mar. 8, 2005; 70 FR 56825, Sept. 29, 2005; 71 FR 76580, 76596, Dec. 21, 2006; 72 FR 35310, 35321, June 27, 2007.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3,

9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 78l, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 78l, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3,

and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: EFFECTIVE DATE NOTE: 72 FR 35310, 35321, June 27, 2007, revised paragraph (c), effective Aug. 27, 2007.]



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 240.15d-15

§ 15 Controls and Procedures [Implementing Sarbanes- Oxley §§ 302, 906].

(a) Every issuer that files reports under section 15(d) of the Act (*15 U.S.C. 78o(d)*), other than an Asset Backed Issuer (as defined in § 229.1101 of this chapter), a small business investment company registered on Form N-5 (§ § 239.24 and 274.5 of this chapter), or a unit investment trust as defined in section 4(2) of the Investment Company Act of 1940 (*15 U.S.C. 80a-4(2)*), must maintain disclosure controls and procedures (as defined in paragraph (e) of this section) and, if the issuer either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year, internal control over financial reporting (as defined in paragraph (f) of this section).

(b) Each such issuer's management must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness of the issuer's disclosure controls and procedures, as of the end of each fiscal quarter, except that management must perform this evaluation:

(1) In the case of a foreign private issuer (as defined in § 240.3b-4) as of the end of each fiscal year; and

(2) In the case of an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), within the 90-day period prior to the filing date of each report requiring certification under § 270.30a-2 of this chapter.

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, (*15 U.S.C. 80a-8*) must evaluate, with the participation of the issuer's principal executive and

principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.

(d) The management of each such issuer that previously either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (*15 U.S.C. 78m(a) or 78o(d)*) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

(e) For purposes of this section, the term disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (*15 U.S.C. 78a et seq.*) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(f) The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

Legislative History

HISTORY: [67 FR 57276, 57290, Sept. 9, 2002; 68 FR 5348, 5364, Feb. 3, 2003; 68 FR 36636, 36667, June 18, 2003; 69 FR 9722, Mar. 1, 2004; 70 FR 1506, 1622, Jan. 7, 2005; 70 FR 11528, Mar. 8, 2005; 70 FR 56825, Sept. 29, 2005; 71 FR 76580, 76596, Dec. 21, 2006; 72 FR 35310, 35322, June 27, 2007.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1)). Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 78l, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs. 12, 14 and 17, 15 U.S.C. 78l, 78n and 78g; Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also

issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub. L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 71 FR 76580, 76596, Dec. 21, 2006, amended this section, effective Feb. 20, 2007. For compliance date information, *see* 71 FR 76580, 76581, Dec. 21, 2006; 72 FR 35310, 35322, June 27, 2007, revised paragraph (c), effective Aug. 27, 2007.]



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice Sarbanes-Oxley § 404

§ Oxley 404 Management Assessment of Internal Controls (15 USC 7262)

(a) Rules Required.-- The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78m or 78o(d)*) to contain an internal control report, which shall--

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) Internal Control Evaluation and Reporting.-- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR §§ 210.1-02

§ 02 Definitions of Terms used in Regulation S-X.

Unless the context otherwise requires, terms defined in the general rules and regulations or in the instructions to the applicable form, when used in Regulation S-X (this part 210), shall have the respective meanings given in such instructions or rules. In addition, the following terms shall have the meanings indicated in this section unless the context otherwise requires.

(a)

(1) Accountant's report.

The term accountant's report, when used in regard to financial statements, means a document in which an independent public or certified public accountant indicates the scope of the audit (or examination) which he has made and sets forth his opinion regarding the financial statements taken as a whole, or an assertion to the effect that an overall opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor shall be stated.

(2) Attestation report on internal control over financial reporting. The term attestation report on internal control over financial reporting means a report in which a registered public accounting firm expresses an opinion, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting (as defined in § 240.13a-15(f) or 240.15d-15(f) of this chapter), except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion.

(3) Attestation report on assessment of compliance with servicing criteria for asset-backed securities. The term attestation report on assessment of compliance with servicing criteria for asset-backed securities means a report in which a registered public accounting firm, as required by § 240.13a-18(c) or 240.15d-18(c) of this chapter, expresses an

opinion, or states that an opinion cannot be expressed, concerning an asserting party's assessment of compliance with servicing criteria, as required by § 240.13a-18(b) or 240.15d-18(b) of this chapter, in accordance with standards on attestation engagements. When an overall opinion cannot be expressed, the registered public accounting firm must state why it is unable to express such an opinion.

(4) Definitions of terms related to internal control over financial reporting. Material weakness means a deficiency, or a combination of deficiencies, in internal control over financial reporting (as defined in § 240.13a-15(f) or 240.15d-15(f) of this chapter) such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis. Significant deficiency means a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting.

(b) Affiliate.

An affiliate of, or a person affiliated with, a specific person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(c) Amount.

The term amount, when used in regard to securities, means the principal amount if relating to evidences of indebtedness, the number of shares if relating to shares, and the number of units if relating to any other kind of security.

(d) Audit (or examination).

Audit (or examination). The term audit (or examination), when used in regard to financial statements, means an examination of the financial statements by an independent accountant in accordance with generally accepted auditing standards, as may be modified or supplemented by the Commission, for the purpose of expressing an opinion thereon.

(e) Bank holding company.

The term bank holding company means a person which is engaged, either directly or indirectly, primarily in the business of owning securities of one or more banks for the purpose, and with the effect, of exercising control.

(f) Certified.

The term certified, when used in regard to financial statements, means examined and reported upon with an opinion expressed by an independent public or certified public accountant.

(g) Control.

The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.

(h) Development stage company.

A company shall be considered to be in the development stage if it is devoting substantially all of its efforts to establishing a new business and either of the following conditions exists: (1) Planned principal operations have not commenced. (2) Planned principal operations have commenced, but there has been no significant revenue therefrom.

(i) Equity security.

The term equity security means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.

(j) Fifty-percent-owned person.

The term 50-percent-owned person, in relation to a specified person, means a person approximately 50 percent of whose outstanding voting shares is owned by the specified person either directly, or indirectly through one or more intermediaries.

(k) Fiscal year.

The term fiscal year means the annual accounting period or, if no closing date has been adopted, the calendar year ending on December 31.

(l) Foreign business.

A business that is majority owned by persons who are not citizens or residents of the United States and is not organized under the laws of the United States or any state thereof, and either:

(1) More than 50 percent of its assets are located outside the United States; or

(2) The majority of its executive officers and directors are not United States citizens or residents.

(m) Insurance holding company.

The term insurance holding company means a person which is engaged, either directly or indirectly, primarily in the business of owning securities of one or more insurance companies for the purpose, and with the effect, of exercising control.

(n) Majority-owned subsidiary.

The term majority-owned subsidiary means a subsidiary more than 50 percent of whose outstanding voting shares is owned by its parent and/or the parent's other majority-owned subsidiaries.

(o) Material.

The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters about which an average prudent investor ought reasonably to be informed.

(p) Parent.

A parent of a specified person is an affiliate controlling such person directly, or indirectly through one or more intermediaries.

(q) Person.

The term person means an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization.

(r) Principal holder of equity securities.

The term principal holder of equity securities, used in respect of a registrant or other person named in a particular statement or report, means a holder of record or a known beneficial owner of more than 10 percent of any class of equity securities of the registrant or other person, respectively, as of the date of the related balance sheet filed.

(s) Promoter.

The term promoter includes:

- (1) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes

initiative in founding and organizing the business or enterprise of an issuer;

(2) A Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.

(t) Registrant.

The term registrant means the issuer of the securities for which an application, a registration statement, or a report is filed.

(u) Related parties.

The term related parties is used as that term is defined in the Glossary to Statement of Financial Accounting Standards No. 57, "Related Party Disclosures."

(v) Share.

The term share means a share of stock in a corporation or unit of interest in an unincorporated person.

(w) Significant subsidiary.

The term significant subsidiary means a subsidiary, including its subsidiaries, which meets any of the following conditions:

(1) The registrant's and its other subsidiaries' investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year (for a proposed business combination to be accounted for as a pooling of interests, this condition is also met when the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated); or

(2) The registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds 10 percent of the total assets of the registrants and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(3) The registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle of the subsidiary exceeds 10 percent of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year.

Note to paragraph (w): A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles shall make the prescribed tests using amounts determined under U.S. Generally Accepted Accounting Principles. A foreign private issuer that files its financial statements in accordance with IFRS as issued by the IASB shall make the prescribed tests using amounts determined under IFRS as issued by the IASB.

Computational note: For purposes of making the prescribed income test the following guidance should be applied:

1. When a loss has been incurred by either the parent and its subsidiaries consolidated or the tested subsidiary, but not both, the equity in the income or loss of the tested subsidiary should be excluded from the income of the registrant and its subsidiaries consolidated for purposes of the computation.

2. If income of the registrant and its subsidiaries consolidated for the most recent fiscal year is at least 10 percent lower than the average of the income for the last five fiscal years, such average income should be substituted for purposes of the computation. Any loss years should be omitted for purposes of computing average income.

3. Where the test involves combined entities, as in the case of determining whether summarized financial data should be presented, entities reporting losses shall not be aggregated with entities reporting income.

(x) Subsidiary.

A subsidiary of a specified person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.

(y) Totally held subsidiary.

The term totally held subsidiary means a subsidiary (1) substantially all of whose outstanding equity securities are owned by its parent and/or the parent's other totally held subsidiaries, and (2) which is not indebted to any person other than its parent and/or the parent's other totally held subsidiaries, in an amount which is material in relation to the particular subsidiary, excepting indebtedness incurred in the ordinary course of business which is not overdue and which matures within 1 year from the date of its creation, whether evidenced by securities or not. Indebtedness of a subsidiary which is secured by its parent by guarantee, pledge, assignment, or otherwise is to be excluded for purposes of paragraph (x)(2) of this section.

(z) Voting shares.

The term voting shares means the sum of all rights, other than as affected by events of default, to vote for election of directors and/or the sum of all interests in an unincorporated person.

(aa) Wholly owned subsidiary.

The term wholly owned subsidiary means a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries.

(bb) Summarized financial information.

(1) Except as provided in paragraph (aa)(2), summarized financial information referred to in this regulation shall mean the presentation of summarized information as to the assets, liabilities and results of operations of the entity for which the information is required. Summarized financial information shall include the following disclosures:

(i) Current assets, noncurrent assets, current liabilities, noncurrent liabilities, and, when applicable, redeemable preferred stocks (*see* § 210.5-02.28) and minority interests (for specialized industries in which classified balance sheets are normally not presented, information shall be provided as to the nature and amount of the major components of assets and liabilities);

(ii) Net sales or gross revenues, gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues), income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle, and net income or loss (for specialized industries, other information may be substituted for sales and related costs and expenses if necessary for a more meaningful presentation); and

(2) Summarized financial information for unconsolidated subsidiaries and 50 percent or less owned persons referred to in and required by § 210.10-01(b) for interim periods shall include the information required by paragraph (aa)(1)(ii) of this section.

Legislative History

HISTORY: [37 FR 14593, July 21, 1972, as amended at 38 FR 6066, Mar. 6, 1973; 39 FR 17931, May 22, 1974; 40 FR 55835, Dec. 2, 1975; 45 FR 63668, Sept. 25, 1980; 46 FR 56178, Nov. 16, 1981; 47 FR 29836, July 9, 1982; 50 FR 25214, June 18, 1985; 50 FR 49531, Dec. 3, 1985; 59 FR 65636, Dec. 20, 1994; 62 FR 12743, 12749, March 18, 1997; 68 FR 36636, 36660, June 18, 2003; 69 FR 9722, Mar. 1, 2004; 70 FR 1506, 1593, Jan. 7, 2005; 70 FR 11528, Mar. 8, 2005; 70 FR 56825, Sept. 29, 2005; 72 FR 35310, 35320, June 27, 2007; 72 FR 44924, 44927, Aug. 9, 2007; 73 FR 986, 1009, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

NOTES: [EFFECTIVE DATE NOTE: 72 FR 35310, 35320, June 27, 2007, amended this section, effective Aug. 27, 2007; 72 FR 44924, 44927, Aug. 9, 2007, amended this section, effective Sept. 10, 2007; 73 FR 986, 1009, Jan. 4, 2008, added a note following paragraph (w)(3), effective Mar. 4, 2008. For compliance date information, *see* 73 FR 986, Jan. 4, 2008.]



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 229.308

§ 308 (Item 308) Internal Control Over Financial Reporting.

(a) Management's annual report on internal control over financial reporting. Provide a report of management on the registrant's internal control over financial reporting (as defined in § 240.13a-15(f) or 240.15d-15(f) of this chapter) that contains:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by paragraph (c) of § 240.13a-15 or 240.15d-15 of this chapter;

(3) Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting; and

(4) A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on the registrant's internal control over financial reporting.

(b) Attestation report of the registered public accounting firm. Provide the registered public accounting firm's attestation report on the registrant's internal control over financial reporting in the registrant's annual report containing the disclosure required by this Item.

(c) Changes in internal control over financial reporting. Disclose any change in the registrant's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of § 240.13a-15 or 240.15d-15 of this chapter that occurred during the registrant's last fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

Instructions to Item 308.

1. A registrant need not comply with paragraphs (a) and (b) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act (*15 U.S.C. 78m or 78o(d)*) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. A registrant that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

2. The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting.

Legislative History

HISTORY: [68 FR 36636, 36663, June 18, 2003; 69 FR 9722, Mar. 1, 2004; 70 FR 1506, 1594, Jan. 7, 2005; 70 FR 11528, Mar. 8, 2005; 70 FR 56825, Sept. 29, 2005; 71 FR 76580, 76595, Dec. 21, 2006; 72 FR 35310, 35321, June 27, 2007.]

AUTHORITY: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted. Section 229.303 is also issued under secs. 3(a) and 401(a), Pub. L. No. 107-204, 116 Stat. 745. Section 229.307 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 229.401 is also issued under secs. 3(a) and 407, Pub. L. 107-204, 116 Stat. 745. Section 229.406 is also issued under secs. 3(a) and 406, Pub. L. 107-204, 116 Stat. 745. Section 229.601 is also issued under secs. 3(a) and 406, Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 71 FR 76580, 76595, Dec. 21, 2006, amended this section, effective Feb. 20, 2007. For compliance date information, see 71 FR 76580, 76581, Dec. 21, 2006; 72 FR 35310, 35321, June 27, 2007, revised paragraphs (a)(4) and (b), effective Aug. 27, 2007.]



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Appendix E FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CERTIFICATION OF PERIODIC REPORTS AND MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

2-E Corporate Governance: Law and Practice 17 CFR § 229.307

§ 307 (Item 307) Disclosure Controls and Procedures.

Disclose the conclusions of the registrant's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures (as defined in § 240.13a-15(e) or 240.15d-15(e) of this chapter) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of § 240.13a-15 or 240.15d-15 of this chapter.

Legislative History

HISTORY: [67 FR 57276, 57287, Sept. 9, 2002; 68 FR 36636, 36663, June 18, 2003; 69 FR 9722, Mar. 1, 2004; 70 FR 11528, Mar. 8, 2005; 70 FR 56825, Sept. 29, 2005.]

AUTHORITY: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38, 80av39, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted. Section 229.303 is also issued under secs. 3(a) and 401(a), Pub. L. No. 107-204, 116 Stat. 745. Section 229.307 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 229.401 is also issued under secs. 3(a) and 407, Pub.L. 107-204, 116 Stat. 745. Section 229.406 is also issued under secs. 3(a) and 406, Pub.L. 107-204, 116 Stat. 745. Section 229.601 is also issued under secs. 3(a) and 406, Pub.L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 36636, 36663, June 18, 2003, revised this section, effective Aug. 14, 2003. For compliance date information, *see* 68 FR 36636, June 18, 2003, 69 FR 9722, Mar. 1, 2004, 70 FR 11528, Mar. 8, 2005, and 70 FR 56825, Sept. 29, 2005.]



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Appendix F FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO EXECUTIVE
COMPENSATION, LOANS TO EXECUTIVES AND INSIDER TRADING DURING PENSION FUND
BLACKOUT PERIODS

2-F Corporate Governance: Law and Practice Appendix F.syn

**§ F.syn Synopsis to Appendix F: FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO
EXECUTIVE COMPENSATION, LOANS TO EXECUTIVES AND INSIDER TRADING DURING PENSION
FUND BLACKOUT PERIODS**

Sarbanes-Oxley § 304 Forfeiture of Certain Bonuses and Profits (15 USC 7243)

Sarbanes-Oxley § 306 Insider Trading During Pension Fund Blackout Periods (15 USC 7244)

17 CFR §§ 245.100-245.104 ["Regulation BTR --Blackout Trading Restriction" & Implementing Prohibition of
Sarbanes-Oxley § 306 Against Insider Trades During Pension Fund Blackout Periods]

Sarbanes-Oxley § 402 Enhanced Conflict of Interest Provisions [Including Prohibitions on Personal Loans to
Directors and Executive Officers]



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Appendix F FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO EXECUTIVE
COMPENSATION, LOANS TO EXECUTIVES AND INSIDER TRADING DURING PENSION FUND
BLACKOUT PERIODS

2-F Corporate Governance: Law and Practice Sarbanes-Oxley § 304

§ Oxley 304 Forfeiture of Certain Bonuses and Profits (15 USC 7243)

(a) Additional Compensation Prior to Noncompliance With Commission Financial Reporting Requirements.-- If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) Commission Exemption Authority.-- The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

HISTORY: [July 30, 2002, P.L. 107-204, Title III, § 304, 116 Stat. 778.]



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Appendix F FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO EXECUTIVE
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2-F Corporate Governance: Law and Practice Sarbanes-Oxley § 306

§ Oxley 306 Insider Trading During Pension Fund Blackout Periods (15 USC 7244)

(a) Prohibition of Insider Trading During Pension Fund Blackout Periods.--

(1) In general.--Except to the extent otherwise provided by rule of the Commission pursuant to paragraph (3), it shall be unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer.

(2) Remedy.--

(A) In general.--Any profit realized by a director or executive officer referred to in paragraph (1) from any purchase, sale, or other acquisition or transfer in violation of this subsection shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such director or executive officer in entering into the transaction.

(B) Actions to recover profits.--An action to recover profits in accordance with this subsection may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer fails or refuses to bring such action within 60 days after the date of request, or fails diligently to prosecute the action thereafter, except that no such suit shall be brought more than 2 years after the date on which such profit was realized.

(3) Rulemaking Authorized.--The Commission shall, in consultation with the Secretary of Labor, issue rules to clarify the application of this subsection and to prevent evasion thereof. Such rules shall provide for the application of the requirements of paragraph (1) with respect to entities treated as a single employer with respect to an issuer under *section 414(b), (c), (m), or (o) of the Internal Revenue Code of 1986* to the extent necessary to clarify the application of such requirements and to prevent evasion thereof. Such rules may also provide for appropriate exceptions from the requirements of this subsection, including exceptions for purchases pursuant to an automatic dividend reinvestment program or purchases or sales made pursuant to an advance election.

(4) Blackout period.--For purposes of this subsection, the term "blackout period," with respect to the equity securities of any issuer--

(A) means any period of more than 3 consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan; and

(B) does not include, under regulations which shall be prescribed by the Commission--

(i) a regularly scheduled period in which the participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer, if such period is--

(I) incorporated into the individual account plan; and

(II) timely disclosed to employees before becoming participants under the individual account plan or as a subsequent amendment to the plan; or

(ii) any suspension described in subparagraph (A) that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, in an individual account plan by reason of a corporate merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor.

(5) Individual account plan.--For purposes of this subsection, the term "individual account plan" has the meaning provided in section 3(34) of the Employee Retirement Income Security Act of 1974 (*29 U.S.C. 1002(34)*), except that such term shall not include a one-participant retirement plan (within the meaning of section 101(i)(8)(B) of such Act (*29 U.S.C. 1021(i)(8)(B)*)).

(6) Notice to directors, executive officers, and the commission.--In any case in which a director or executive officer is subject to the requirements of this subsection in connection with a blackout period (as defined in paragraph (4)) with respect to any equity securities, the issuer of such equity securities shall timely notify such director or officer and the Securities and Exchange Commission of such blackout period.

(b) Notice Requirements to Participants and Beneficiaries under ERISA.--

(1) In general.--Section 101 of the Employee Retirement Income Security Act of 1974 (*29 U.S.C. 1021*) is amended by redesignating the second subsection (h) as subsection (j), and by inserting after the first subsection (h) the following new subsection:

"(i) Notice of Blackout Periods to Participant or Beneficiary Under Individual Account Plan.--

"(1) Duties of plan administrator.--In advance of the commencement of any blackout period with respect to an individual account plan, the plan administrator shall notify the plan participants and beneficiaries who are affected by such action in accordance with this subsection.

"(2) Notice requirements.--

"(A) In general.--The notices described in paragraph (1) shall be written in a manner calculated to be understood by the average plan participant and shall include--

"(i) the reasons for the blackout period,

"(ii) an identification of the investments and other rights affected,

"(iii) the expected beginning date and length of the blackout period,

"(iv) in the case of investments affected, a statement that the participant or beneficiary should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets credited to their accounts during the blackout period, and

"(v) such other matters as the Secretary may require by regulation.

"(B) Notice to participants and beneficiaries.--Except as otherwise provided in this subsection, notices described in paragraph (1) shall be furnished to all participants and beneficiaries under the plan to whom the blackout period applies at least 30 days in advance of the blackout period.

"(C) Exception to 30-day notice requirement.--In any case in which--

"(i) a deferral of the blackout period would violate the requirements of subparagraph (A) or (B) of section 404(a)(1), and a fiduciary of the plan reasonably so determines in writing, or

"(ii) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator, and a fiduciary of the plan reasonably so determines in writing,

subparagraph (B) shall not apply, and the notice shall be furnished to all participants and beneficiaries under the

plan to whom the blackout period applies as soon as reasonably possible under the circumstances unless such a notice in advance of the termination of the blackout period is impracticable.

"(D) Written notice.--The notice required to be provided under this subsection shall be in writing, except that such notice may be in electronic or other form to the extent that such form is reasonably accessible to the recipient.

"(E) Notice to issuers of employer securities subject to blackout period.--In the case of any blackout period in connection with an individual account plan, the plan administrator shall provide timely notice of such blackout period to the issuer of any employer securities subject to such blackout period.

"(3) Exception for blackout periods with limited applicability.--In any case in which the blackout period applies only to 1 or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor and occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of such merger, acquisition, divestiture, or transaction, the requirement of this subsection that the notice be provided to all participants and beneficiaries shall be treated as met if the notice required under paragraph (1) is provided to such participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.

"(4) Changes in length of blackout period.--If, following the furnishing of the notice pursuant to this subsection, there is a change in the beginning date or length of the blackout period (specified in such notice pursuant to paragraph (2)(A)(iii)), the administrator shall provide affected participants and beneficiaries notice of the change as soon as reasonably practicable. In relation to the extended blackout period, such notice shall meet the requirements of paragraph (2)(D) and shall specify any material change in the matters referred to in clauses (i) through (v) of paragraph (2)(A).

"(5) Regulatory exceptions.--The Secretary may provide by regulation for additional exceptions to the requirements of this subsection which the Secretary determines are in the interests of participants and beneficiaries.

"(6) Guidance and model notices.--The Secretary shall issue guidance and model notices which meet the requirements of this subsection.

"(7) Blackout period.--For purposes of this subsection--

"(A) In general.--The term 'blackout period' means, in connection with an individual account plan, any period for which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of such plan, to direct or diversify assets credited to their accounts, to obtain loans from the plan, or to obtain distributions from the plan is temporarily suspended, limited, or restricted, if such suspension, limitation, or restriction is for any period of more than 3 consecutive business days.

"(B) Exclusions.--The term 'blackout period' does not include a suspension, limitation, or restriction--

"(i) which occurs by reason of the application of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934),

"(ii) which is a change to the plan which provides for a regularly scheduled suspension, limitation, or restriction which is disclosed to participants or beneficiaries through any summary of material modifications, any materials describing specific investment alternatives under the plan, or any changes thereto, or

"(iii) which applies only to 1 or more individuals, each of whom is the participant, an alternate payee (as defined in section 206(d)(3)(K)), or any other beneficiary pursuant to a qualified domestic relations order (as defined in section 206(d)(3)(B)(i)).

"(8) Individual account plan.--"(A) In general.--For purposes of this subsection, the term 'individual account plan'

shall have the meaning provided such term in section 3(34), except that such term shall not include a one-participant retirement plan.

"(B) One-participant retirement plan.--For purposes of subparagraph (A), the term 'one-participant retirement plan' means a retirement plan that--

"(i) on the first day of the plan year--

"(I) covered only the employer (and the employer's spouse) and the employer owned the entire business (whether or not incorporated), or

"(II) covered only one or more partners (and their spouses) in a business partnership (including partners in an S or C corporation (as defined in *section 1361(a) of the Internal Revenue Code of 1986*)),

"(ii) meets the minimum coverage requirements of *section 410(b) of the Internal Revenue Code of 1986* (as in effect on the date of the enactment of this paragraph) without being combined with any other plan of the business that covers the employees of the business,

"(iii) does not provide benefits to anyone except the employer (and the employer's spouse) or the partners (and their spouses),

"(iv) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control, and

"(v) does not cover a business that leases employees."

(2) Issuance of initial guidance and model notice.--The Secretary of Labor shall issue initial guidance and a model notice pursuant to section 101(i)(6) of the Employee Retirement Income Security Act of 1974 (as added by this subsection) not later than January 1, 2003. Not later than 75 days after the date of the enactment of this Act, the Secretary shall promulgate interim final rules necessary to carry out the amendments made by this subsection.

(3) Civil penalties for failure to provide notice.--Section 502 of such Act (*29 U.S.C. 1132*) is amended--

(A) in subsection (a)(6), by striking "(5), or (6)" and inserting "(5), (6), or (7)";

(B) by redesignating paragraph (7) of subsection (c) as paragraph (8); and

(C) by inserting after paragraph (6) of subsection (c) the following new paragraph:

"(7) The Secretary may assess a civil penalty against a plan administrator of up to \$ 100 a day from the date of the plan administrator's failure or refusal to provide notice to participants and beneficiaries in accordance with section 101(i). For purposes of this paragraph, each violation with respect to any single participant or beneficiary shall be treated as a separate violation."

(3) Plan amendments.--If any amendment made by this subsection requires an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after the effective date of this section, if--

(A) during the period after such amendment made by this subsection takes effect and before such first plan year, the plan is operated in good faith compliance with the requirements of such amendment made by this subsection, and

(B) such plan amendment applies retroactively to the period after such amendment made by this subsection takes effect and before such first plan year.

(c) Effective Date.-- The provisions of this section (including the amendments made thereby) shall take effect 180 days after the date of the enactment of this Act. Good faith compliance with the requirements of such provisions in advance of the issuance of applicable regulations thereunder shall be treated as compliance with such provisions.

HISTORY: [July 30, 2002, P.L. 107-204, Title III, § 306, 116 Stat. 779.]



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Corporate Governance: Law and Practice

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Appendix F FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO EXECUTIVE
COMPENSATION, LOANS TO EXECUTIVES AND INSIDER TRADING DURING PENSION FUND
BLACKOUT PERIODS

2-F Corporate Governance: Law and Practice 17 CFR §§ 245.100-245.104

**§ 245.100-245.104 ["Regulation BTR --Blackout Trading Restriction" & Implementing Prohibition of
Sarbanes-Oxley § 306 Against Insider Trades During Pension Fund Blackout Periods]**

17 CFR § 245.100 Definitions. As used in Regulation BTR (§§ 245.100 through 245.104), unless the context otherwise requires:

(a) The term acquired in connection with service or employment as a director or executive officer, when applied to a director or executive officer, means that he or she acquired, directly or indirectly, an equity security:

(1) At a time when he or she was a director or executive officer, under a compensatory plan, contract, authorization or arrangement, including, but not limited to, an option, warrants or rights plan, a pension, retirement or deferred compensation plan or a bonus, incentive or profit-sharing plan (whether or not set forth in any formal plan document), including a compensatory plan, contract, authorization or arrangement with a parent, subsidiary or affiliate;

(2) At a time when he or she was a director or executive officer, as a result of any transaction or business relationship described in paragraph (a) of Item 404 of Regulation S-K (§ 229.404 of this chapter) or, in the case of a foreign private issuer, Item 7.B of Form 20-F (§ 249.220f of this chapter) (but without application of the disclosure thresholds of such provisions), to the extent that he or she has a pecuniary interest (as defined in paragraph (1) of this section) in the equity securities;

(3) At a time when he or she was a director or executive officer, as directors' qualifying shares or other securities that he or she must hold to satisfy minimum ownership requirements or guidelines for directors or executive officers;

(4) Prior to becoming, or while, a director or executive officer where the equity security was acquired as a direct or indirect inducement to service or employment as a director or executive officer; or

(5) Prior to becoming, or while, a director or executive officer where the equity security was received as a result of a business combination in respect of an equity security of an entity involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of such entity.

(b) Except as provided in § 245.102, the term blackout period:

(1) With respect to the equity securities of any issuer (other than a foreign private issuer), means any period of more than three consecutive business days during which the ability to purchase, sell or otherwise acquire or transfer an interest in any equity security of such issuer held in an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan with respect to not fewer than 50% of the participants or beneficiaries located in the United States and its territories and possessions under all individual account plans (as defined in paragraph (j) of this section) maintained by the issuer that permit participants or beneficiaries to acquire or hold equity securities of the issuer;

(2) With respect to the equity securities of any foreign private issuer (as defined in § 240.3b-4(c) of this chapter), means any period of more than three consecutive business days during which both:

(i) The conditions of paragraph (b)(1) of this section are met; and

(ii)

(A) The number of participants and beneficiaries located in the United States and its territories and possessions subject to the temporary suspension exceeds 15% of the total number of employees of the issuer and its consolidated subsidiaries; or

(B) More than 50,000 participants and beneficiaries located in the United States and its territories and possessions are subject to the temporary suspension.

(3) In determining the individual account plans (as defined in paragraph (j) of this section) maintained by an issuer for purposes of this paragraph (b):

(i) The rules under *section 414(b), (c), (m) and (o) of the Internal Revenue Code (26 U.S.C. 414(b), (c), (m) and (o))* are to be applied; and

(ii) An individual account plan that is maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens (within the meaning of section 104(b)(4) of the Employee Retirement Income Security Act of 1974 (*29 U.S.C. 1003(b)(4)*)) is not to be considered.

(4) In determining the number of participants and beneficiaries in an individual account plan (as defined in paragraph (j) of this section) maintained by an issuer:

(i) The determination may be made as of any date within the 12-month period preceding the beginning date of the temporary suspension in question; provided that if there has been a significant change in the number of participants or beneficiaries in an individual account plan since the date selected, the determination for such plan must be made as of the most recent practicable date that reflects such change; and

(ii) The determination may be made without regard to overlapping plan participation.

(c)

(1) The term director has, except as provided in paragraph (c)(2) of this section, the meaning set forth in section 3(a)(7) of the Exchange Act (*15 U.S.C. 78c(a)(7)*).

(2) In the case of a foreign private issuer (as defined in § 240.3b-4(c) of this chapter), the term director means an individual within the definition set forth in section 3(a)(7) of the Exchange Act who is a management employee of the issuer.

(d) The term derivative security has the meaning set forth in § 240.16a-1(c) of this chapter.

(e) The term equity security has the meaning set forth in section 3(a)(11) of the Exchange Act (*15 U.S.C. 78c(a)(11)*) and § 240.3a11-1 of this chapter.

(f) The term equity security of the issuer means any equity security or derivative security relating to an issuer, whether or not issued by that issuer.

(g) The term Exchange Act means the Securities Exchange Act of 1934 (*15 U.S.C. 78a et seq.*).

(h)

(1) The term executive officer has, except as provided in paragraph (h)(2) of this section, the meaning set forth in § 240.16a-1(f) of this chapter.

(2) In the case of a foreign private issuer (as defined in § 240.3b-4(c) of this chapter), the term executive officer means the principal executive officer or officers, the principal financial officer or officers and the principal accounting officer or officers of the issuer.

(i) The term exempt security has the meaning set forth in section 3(a)(12) of the Exchange Act (*15 U.S.C. 78c(a)(12)*).

(j) The term individual account plan means a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account, except that such term does not include a one-participant retirement plan (within the meaning of section 101(i)(8)(B) of the Employee Retirement Income Security Act of 1974 (*29 U.S.C. 1021(i)(8)(B)*)), nor does it include a pension plan in which participation is limited to directors of the issuer.

(k) The term issuer means an issuer (as defined in section 3(a)(8) of the Exchange Act (*15 U.S.C. 78c(a)(8)*)), the securities of which are registered under section 12 of the Exchange Act (*15 U.S.C. 78l*) or that is required to file reports under section 15(d) of the Exchange Act (*15 U.S.C. 78o(d)*) or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (*15 U.S.C. 77a et seq.*) and that it has not withdrawn.

(l) The term pecuniary interest has the meaning set forth in § 240.16a-1(a)(2)(i) of this chapter and the term indirect pecuniary interest has the meaning set forth in § 240.16a-1(a)(2)(ii) of this chapter. Section 240.16a-1(a)(2)(iii) of this chapter also shall apply to determine pecuniary interest for purposes of this regulation.

HISTORY: [68 FR 4338, 4355, Jan. 28, 2003; 71 FR 53158, 53263, Sept. 8, 2006.]

AUTHORITY: 15 U.S.C. 78w(a). Sections 245.100-245.104 are also issued under secs. 3 (a) and 306(a), Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 71 FR 53158, 53263, Sept. 8, 2006, amended paragraph (a)(2), effective Nov. 7, 2006. For compliance date information, *see* 71 FR 53158, Sept. 8, 2006.]

17 CFR § 245.101 Prohibition of insider trading during pension fund blackout periods.

(a) Except to the extent otherwise provided in paragraph (c) of this section, it is unlawful under section 306(a)(1) of the Sarbanes-Oxley Act of 2002 (*15 U.S.C. 7244(a)(1)*) for any director or executive officer of an issuer of any equity security (other than an exempt security), directly or indirectly, to purchase, sell or otherwise acquire or transfer any equity security of the issuer (other than an exempt security) during any blackout period with respect to such equity security, if such director or executive officer acquires or previously acquired such equity security in connection with his or her service or employment as a director or executive officer.

(b) For purposes of section 306(a)(1) of the Sarbanes-Oxley Act of 2002, any sale or other transfer of an equity security of the issuer during a blackout period will be treated as a transaction involving an equity security "acquired in connection with service or employment as a director or executive officer" (as defined in § 245.100(a)) to the extent that the director or executive officer has a pecuniary interest (as defined in § 245.100(l)) in such equity security, unless the director or executive officer establishes by specific identification of securities that the transaction did not involve an equity security "acquired in connection with service or employment as a director or executive officer." To establish that the equity security was not so acquired, a director or executive officer must identify the source of the equity securities and demonstrate that he or she has utilized the same specific identification for any purpose related to the transaction (such as tax reporting and any applicable disclosure and reporting requirements).

(c) The following transactions are exempt from section 306(a)(1) of the Sarbanes-Oxley Act of 2002:

(1) Any acquisition of equity securities resulting from the reinvestment of dividends in, or interest on, equity securities of the same issuer if the acquisition is made pursuant to a plan providing for the regular reinvestment of dividends or interest and the plan provides for broad-based participation, does not discriminate in favor of employees of the issuer and operates on substantially the same terms for all plan participants;

(2) Any purchase or sale of equity securities of the issuer pursuant to a contract, instruction or written plan entered into by the director or executive officer that satisfies the affirmative defense conditions of § 240.10b5-1(c) of this chapter; provided that the director or executive officer did not enter into or modify the contract, instruction or written plan during the blackout period (as defined in § 245.100(b)) in question, or while aware of the actual or approximate beginning or ending dates of that blackout period (whether or not the director or executive officer received notice of the blackout period as required by Section 306(a)(6) of the Sarbanes-Oxley Act of 2002 (*15 U.S.C. 7244(a)(6)*)).

(3) Any purchase or sale of equity securities, other than a Discretionary Transaction (as defined in § 240.16b-3(b)(1) of this chapter), pursuant to a Qualified Plan (as defined in § 240.16b-3(b)(4) of this chapter), an Excess Benefit Plan (as defined in § 240.16b-3(b)(2) of this chapter) or a Stock Purchase Plan (as defined in § 240.16b-3(b)(5) of this chapter) (or, in the case of a foreign private issuer, pursuant to an employee benefit plan that either (i) has been

approved by the taxing authority of a foreign jurisdiction, or (ii) is eligible for preferential treatment under the tax laws of a foreign jurisdiction because the plan provides for broad-based employee participation); provided that a Discretionary Transaction that meets the conditions of paragraph (c)(2) of this section also shall be exempt;

(4) Any grant or award of an option, stock appreciation right or other equity compensation pursuant to a plan that, by its terms:

(i) Permits directors or executive officers to receive grants or awards; and

(ii) Either:

(A) States the amount and price of securities to be awarded to designated directors and executive officers or categories of directors and executive officers (though not necessarily to others who may participate in the plan) and specifies the timing of awards to directors and executive officers; or

(B) Sets forth a formula that determines the amount, price and timing, using objective criteria (such as earnings of the issuer, value of the securities, years of service, job classification, and compensation levels);

(5) Any exercise, conversion or termination of a derivative security that the director or executive officer did not write or acquire during the blackout period (as defined in § 245.100(b)) in question, or while aware of the actual or approximate beginning or ending dates of that blackout period (whether or not the director or executive officer received notice of the blackout period as required by Section 306(a)(6) of the Sarbanes-Oxley Act of 2002); and either:

(i) The derivative security, by its terms, may be exercised, converted or terminated only on a fixed date, with no discretionary provision for earlier exercise, conversion or termination; or

(ii) The derivative security is exercised, converted or terminated by a counterparty and the director or executive officer does not exercise any influence on the counterparty with respect to whether or when to exercise, convert or terminate the derivative security;

(6) Any acquisition or disposition of equity securities involving a bona fide gift or a transfer by will or the laws of descent and distribution;

(7) Any acquisition or disposition of equity securities pursuant to a domestic relations order, as defined in the Internal Revenue Code or Title I of the Employment Retirement Income Security Act of 1974, or the rules thereunder;

(8) Any sale or other disposition of equity securities compelled by the laws or other requirements of an applicable jurisdiction;

(9) Any acquisition or disposition of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law;

(10) The increase or decrease in the number of equity securities held as a result of a stock split or stock dividend applying equally to all securities of that class, including a stock dividend in which equity securities of a different issuer are distributed; and the acquisition of rights, such as shareholder or pre-emptive rights, pursuant to a pro rata grant to all holders of the same class of equity securities; and

(11) Any acquisition or disposition of an asset-backed security, as defined in § 229.1101 of this chapter.

HISTORY: [68 FR 4338, 4356, Jan. 28, 2003; 70 FR 1506, 1623, Jan. 7, 2005.]

AUTHORITY: 15 U.S.C. 78w(a). Sections 245.100-245.104 are also issued under secs. 3 (a) and 306(a), Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 70 FR 1506, 1623, Jan. 7, 2005, amended paragraph (c), effective Mar. 8, 2005. For compliance date information, *see* 70 FR 1506, Jan. 7, 2005.]

17 CFR § 245.102 Exceptions to definition of blackout period. The term "blackout period," as defined in § 245.100(b), does not include:

(a) A regularly scheduled period in which participants and beneficiaries may not purchase, sell or otherwise acquire or transfer an interest in any equity security of an issuer, if a description of such period, including its frequency and duration and the plan transactions to be suspended or otherwise affected, is:

(1) Incorporated into the individual account plan or included in the documents or instruments under which the plan operates; and

(2) Disclosed to an employee before he or she formally enrolls, or within 30 days following formal enrollment, as a

participant under the individual account plan or within 30 days after the adoption of an amendment to the plan. For purposes of this paragraph (a)(2), the disclosure may be provided in any graphic form that is reasonably accessible to the employee; or

(b) Any trading suspension described in § 245.100(b) that is imposed in connection with a corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor, the principal purpose of which is to permit persons affiliated with the acquired or divested entity to become participants or beneficiaries, or to cease to be participants or beneficiaries, in an individual account plan; provided that the persons who become participants or beneficiaries in an individual account plan are not able to participate in the same class of equity securities after the merger, acquisition, divestiture or similar transaction as before the transaction.

HISTORY: [68 FR 4338, 4357, Jan. 28, 2003.]

AUTHORITY: 15 U.S.C. 78w(a). Sections 245.100-245.104 are also issued under secs. 3 (a) and 306(a), Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 4338, 4357, Jan. 28, 2003, added Part 245, effective Jan. 26, 2003.]

17 CFR § 245.103 Issuer right of recovery; right of action by equity security owner.

(a) Recovery of profits. Section 306(a)(2) of the Sarbanes-Oxley Act of 2002 (*15 U.S.C. 7244(a)(2)*) provides that any profit realized by a director or executive officer from any purchase, sale or other acquisition or transfer of any equity security of an issuer in violation of section 306(a)(1) of that Act (*15 U.S.C. 7244(a)(1)*) will inure to and be recoverable by the issuer, regardless of any intention on the part of the director or executive officer in entering into the transaction.

(b) Actions to recover profit. Section 306(a)(2) of the Sarbanes-Oxley Act of 2002 provides that an action to recover profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any equity security of the issuer in the name and on behalf of the issuer if the issuer fails or refuses to bring such action within 60 days after the date of request, or fails diligently to prosecute the action thereafter, except that no such suit may be brought more than two years after the date on which such profit was realized.

(c) Measurement of profit.

(1) In determining the profit recoverable in an action undertaken pursuant to section 306(a)(2) of the Sarbanes-Oxley Act of 2002 from a transaction that involves a purchase, sale or other acquisition or transfer (other than a grant, exercise, conversion or termination of a derivative security) in violation of section 306(a)(1) of that Act of an equity security of an issuer that is registered pursuant to section 12(b) or 12(g) of the Exchange Act (*15 U.S.C. 78l(b)* or (*g*)) and listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association, profit (including any loss avoided) may be measured by comparing the difference between the amount paid or received for the equity security on the date of the transaction during the blackout period and the average

market price of the equity security calculated over the first three trading days after the ending date of the blackout period.

(2) In determining the profit recoverable in an action undertaken pursuant to section 306(a)(2) of the Sarbanes-Oxley Act of 2002 from a transaction that is not described in paragraph (c)(1) of this section, profit (including any loss avoided) may be measured in a manner that is consistent with the objective of identifying the amount of any gain realized or loss avoided by a director or executive officer as a result of a transaction taking place in violation of section 306(a)(1) of that Act during the blackout period as opposed to taking place outside of such blackout period.

(3) The terms of this section do not limit in any respect the authority of the Commission to seek or determine remedies as the result of a transaction taking place in violation of section 306(a)(1) of the Sarbanes-Oxley Act.

HISTORY: [68 FR 4338, 4357, Jan. 28, 2003.]

AUTHORITY: 15 U.S.C. 78w(a). Sections 245.100-245.104 are also issued under secs. 3 (a) and 306(a), Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 4338, 4357, Jan. 28, 2003, added Part 245, effective Jan. 26, 2003.]

17 CFR § 245.104 Notice.

(a) In any case in which a director or executive officer is subject to section 306(a)(1) of the Sarbanes-Oxley Act of 2002 (*15 U.S.C. 7244(a)(1)*) in connection with a blackout period (as defined in § 245.100(b)) with respect to any equity security, the issuer of the equity security must timely notify each director or officer and the Commission of the blackout period.

(b) For purposes of this section:

(1) The notice must include:

(i) The reason or reasons for the blackout period;

(ii) A description of the plan transactions to be suspended during, or otherwise affected by, the blackout period;

(iii) A description of the class of equity securities subject to the blackout period;

(iv) The length of the blackout period by reference to:

(A) The actual or expected beginning date and ending date of the blackout period; or

(B) The calendar week during which the blackout period is expected to begin and the calendar week during which the blackout period is expected to end, provided that the notice to directors and executive officers describes how, during such week or weeks, a director or executive officer may obtain, without charge, information as to whether the blackout period has begun or ended; and provided further that the notice to the Commission describes how, during the blackout period and for a period of two years after the ending date of the blackout period, a security holder or other interested person may obtain, without charge, the actual beginning and ending dates of the blackout period.

(C) For purposes of this paragraph (b)(1)(iv), a calendar week means a seven-day period beginning on Sunday and ending on Saturday; and

(v) The name, address and telephone number of the person designated by the issuer to respond to inquiries about the blackout period, or, in the absence of such a designation, the issuer's human resources director or person performing equivalent functions.

(2)

(i) Notice to an affected director or executive officer will be considered timely if the notice described in paragraph (b)(1) of this section is provided (in graphic form that is reasonably accessible to the recipient):

(A) No later than five business days after the issuer receives the notice required by section 101(i)(2)(E) of the Employment Retirement Income Security Act of 1974 (29 U.S.C. 1021(i)(2)(E)); or

(B) If no such notice is received by the issuer, a date that is at least 15 calendar days before the actual or expected beginning date of the blackout period.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, the requirement to give advance notice will not apply in any case in which the inability to provide advance notice of the blackout period is due to events that were unforeseeable to, or circumstances that were beyond the reasonable control of, the issuer, and the issuer reasonably so determines in

writing. Determinations described in the preceding sentence must be dated and signed by an authorized representative of the issuer. In any case in which this exception to the advance notice requirement applies, the issuer must provide the notice described in paragraph (b)(1) of this section, as well as a copy of the written determination, to all affected directors and executive officers as soon as reasonably practicable.

(iii) If there is a subsequent change in the beginning or ending dates of the blackout period as provided in the notice to directors and executive officers under paragraph (b)(2)(i) of this section, an issuer must provide directors and executive officers with an updated notice explaining the reasons for the change in the date or dates and identifying all material changes in the information contained in the prior notice. The updated notice is required to be provided as soon as reasonably practicable, unless such notice in advance of the termination of a blackout period is impracticable.

(3) Notice to the Commission will be considered timely if:

(i) The issuer, except as provided in paragraph (b)(3)(ii) of this section, files a current report on Form 8-K (§ 249.308 of this chapter) within the time prescribed for filing the report under the instructions for the form; or

(ii) In the case of a foreign private issuer (as defined in § 240.3b-4(c) of this chapter), the issuer includes the information set forth in paragraph (b)(1) of this section in the first annual report on Form 20-F (§ 249.220f of this chapter) or 40-F (§ 249.240f of this chapter) required to be filed after the receipt of the notice of a blackout period required by 29 *CFR* 2520.101-3(c) within the time prescribed for filing the report under the instructions for the form or in an earlier filed report on Form 6-K (§ 249.306).

(iii) If there is a subsequent change in the beginning or ending dates of the blackout period as provided in the notice to the Commission under paragraph (b)(3)(i) of this section, an issuer must file a current report on Form 8-K containing the updated beginning or ending dates of the blackout period, explaining the reasons for the change in the date or dates and identifying all material changes in the information contained in the prior report. The updated notice is required to be provided as soon as reasonably practicable.

HISTORY: [68 FR 4338, 4358, Jan. 28, 2003.]

AUTHORITY: 15 U.S.C. 78w(a). Sections 245.100-245.104 are also issued under secs. 3 (a) and 306(a), Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 4338, 4358, Jan. 28, 2003, added Part 245, effective Jan. 26, 2003. Compliance Date: Issuers must comply with § 245.104(b)(3)(i) and (iii) of Regulation BTR beginning March 31, 2003.]



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2-F Corporate Governance: Law and Practice Sarbanes-Oxley § 402

§ Oxley 402 Enhanced Conflict of Interest Provisions [Including Prohibitions on Personal Loans to Directors and Executive Officers]

(a) Prohibition on Personal Loans to Executives.-- Section 13 of the Securities Exchange Act of 1934 (*15 U.S.C. 78m*), as amended by this Act, is amended by adding at the end the following:

"(k) Prohibition on Personal Loans to Executives.--

"(1) In general.--In general. It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002 [15 USCS § 7201]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection [enacted July 30, 2002] shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

"(2) Limitation.--Paragraph (1) does not preclude any home improvement and manufactured home loans (as that term is defined in section 5 of the Home Owners' Loan Act (*12 U.S.C. 1464*)), consumer credit (as defined in section 103 of the Truth in Lending Act (*15 U.S.C. 1602*)), or any extension of credit under an open end credit plan (as defined in section 103 of the Truth in Lending Act (*15 U.S.C. 1602*)), or a charge card (as defined in section 127(c)(4)(e) of the Truth in Lending Act (*15 U.S.C. 1637(c)(4)(e)*)), or any extension of credit by a broker or dealer registered under section 15 of this title [15 USCS § 78o] to an employee of that broker or dealer to buy, trade, or carry securities, that is permitted under rules or regulations of the Board of Governors of the Federal Reserve System pursuant to section 7 of this title (other than an extension of credit that would be used to purchase the stock of that issuer), that is--

"(A) made or provided in the ordinary course of the consumer credit business of such issuer;

"(B) of a type that is generally made available by such issuer to the public; and

"(C) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.

"(3) Rule of construction for certain loans.--Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (*12 U.S.C. 1813*)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (*12 U.S.C. 375b*)."

Legislative History

HISTORY: [June 6, 1934, ch 404, Title I, § 13, 48 Stat. 894; Aug. 20, 1964, P.L. 88-467, § 4, 78 Stat. 569; July 29, 1968, P.L. 90-439, § 2, 82 Stat. 454; Dec. 22, 1970, P.L. 91-567, §§ 1, 2, 84 Stat. 1497; June 4, 1975, P.L. 94-29, § 10, 89 Stat. 119; Feb 5, 1976, P.L. 94-210, Title III, § 308(b), 90 Stat 57; Dec. 19, 1977, P.L. 95-213, Title I, § 102, Title II, §§ 202, 203, 91 Stat. 1494, 1498, 1499; June 6, 1983, P.L. 98-38, § 2(a), 97 Stat. 205; Dec. 4, 1987, P.L. 100-181, Title III, §§ 315, 316, 101 Stat. 1256; Feb. 3, 1988, P.L. 100-241, § 12(d), 101 Stat. 1810; Aug. 23, 1988, P.L. 100-418, Title V, Subtitle A, Part I, § 5002, 102 Stat. 1415; Oct. 16, 1990, P.L. 101-432, § 3, 104 Stat. 964. As amended Jan. 16, 2002, P.L. 107-123, § 5, 115 Stat. 2395; July 30, 2002, P.L. 107-204, Title I, § 109(h), Title IV, §§ 401(a), 402(a), 409, 116 Stat. 771, 785, 787, 791.]



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Appendix G FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS

2-G Corporate Governance: Law and Practice Appendix G.syn

§ G.syn Synopsis to Appendix G: FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS

Sarbanes-Oxley § 307 Rules of Professional Responsibility for Attorneys (15 USC 7245)

17 CFR §§ 205.1-205.7 Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission [Implementing Sarbanes-Oxley Act § 307, Rules of Professional Responsibility for Attorneys].

17 CFR § 205.1 Purpose and scope.

17 CFR § 205.2 Definitions.

17 CFR § 205.3 Issuer as client.

17 CFR § 205.4 Responsibilities of supervisory attorneys.

17 CFR § 205.5 Responsibilities of a subordinate attorney.

17 CFR § 205.6 Sanctions and discipline.

17 CFR § 205.7 No private right of action.



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2-G Corporate Governance: Law and Practice Sarbanes-Oxley § 307

§ 307 Rules of Professional Responsibility for Attorneys (15 USC 7245)

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule--

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

HISTORY: [July 30, 2002, P.L. 107-204, Title III, § 307, 116 Stat. 784.]



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2-G Corporate Governance: Law and Practice 17 CFR §§ 205.1-205.7

**§ 205.1-205.7 Standards of Professional Conduct for Attorneys Appearing and Practicing before the
Commission [Implementing Sarbanes-Oxley Act § 307, Rules of Professional Responsibility for Attorneys].**



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§ 1 Purpose and scope.

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

Legislative History

HISTORY: [68 FR 6296, 6320, Feb. 6, 2003.]

AUTHORITY: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 6296, 6320, Feb. 6, 2003, added Part 205, effective Aug. 5, 2003.]



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2-G Corporate Governance: Law and Practice 17 CFR § 205.2

§ 2 Definitions.

For purposes of this part, the following definitions apply:

(a) Appearing and practicing before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or

incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

(b) Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

(c) Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction,

domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

(d) Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

(e) Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

(f) Foreign government issuer means a foreign issuer as defined in *17 CFR 230.405* eligible to register securities on Schedule B of the Securities Act of 1933 (*15 U.S.C. 77a et seq.*, Schedule B).

(g) In the representation of an issuer means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

(h) Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (*15 U.S.C. 78c*)), the securities of which are registered under section 12 of that Act (*15 U.S.C. 78l*), or that is required to file reports under section 15(d) of that Act (*15 U.S.C. 78o(d)*), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (*15 U.S.C. 77a et seq.*), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

(i) Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

(j) Non-appearing foreign attorney means an attorney:

(1) Who is admitted to practice law in a jurisdiction outside the United States;

(2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

(k) Qualified legal compliance committee means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*);

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

(l) Reasonable or reasonably denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

(m) Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

(n) Report means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

Legislative History

HISTORY: [68 FR 6296, 6320, Feb. 6, 2003.]

AUTHORITY: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 6296, 6320, Feb. 6, 2003, added Part 205, effective Aug. 5, 2003.]



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PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS

2-G Corporate Governance: Law and Practice 17 CFR § 205.3

§ 3 Issuer as client.

(a) Representing an issuer. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

(b) Duty to report evidence of a material violation.

(1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

(2) The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material

violation.

(3) Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i) The audit committee of the issuer's board of directors;

(ii) Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*) (if the issuer's board of directors has no audit committee); or

(iii) The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*)).

(4) If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

(5) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

(6) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i) The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A) The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(B) Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i) To investigate such evidence of a material violation; or

(ii) To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

(8) An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9) An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

(10) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

(c) Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee.

(1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2) A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

(d) Issuer confidences.

(1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in *18 U.S.C. 1621*; suborning perjury, proscribed in *18 U.S.C. 1622*; or committing any act proscribed in *18 U.S.C. 1001* that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

Legislative History

HISTORY: [68 FR 6296, 6321, Feb. 6, 2003.]

AUTHORITY: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 6296, 6321, Feb. 6, 2003, added Part 205, effective Aug. 5, 2003.]



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§ 4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c) A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

Legislative History

HISTORY: [68 FR 6296, 6323, Feb. 6, 2003.]

AUTHORITY: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

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2-G Corporate Governance: Law and Practice 17 CFR § 205.5

§ 5 Responsibilities of a subordinate attorney.

(a) An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b) A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c) A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by § 205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under § 205.3(b) has failed to comply with § 205.3.

Legislative History

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2-G Corporate Governance: Law and Practice 17 CFR § 205.6

§ 6 Sanctions and discipline.

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b) An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

Legislative History

HISTORY: [68 FR 6296, 6323, Feb. 6, 2003.]

AUTHORITY: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

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2-G Corporate Governance: Law and Practice 17 CFR § 205.7

§ 7 No private right of action.

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested exclusively in the Commission.

Legislative History

HISTORY: [68 FR 6296, 6323, Feb. 6, 2003.]

AUTHORITY: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

NOTES: [EFFECTIVE DATE NOTE: 68 FR 6296, 6323, Feb. 6, 2003, added Part 205, effective Aug. 5, 2003.]



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Appendix H FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CODES OF ETHICS
FOR SENIOR FINANCIAL OFFICERS

2-H Corporate Governance: Law and Practice Appendix H.syn

**§ H.syn Synopsis to Appendix H: FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO
CODES OF ETHICS FOR SENIOR FINANCIAL OFFICERS**

Sarbanes-Oxley § 406 Code of Ethics for Senior Financial Officers (15 USC 7264)

17 CFR § 229.406 [Regulation S-K Item 406] Code of Ethics (and Instructions) [Implementing Sarbanes-Oxley §
406 Concerning Disclosures for Senior Financial Officers]



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Appendix H FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CODES OF ETHICS
FOR SENIOR FINANCIAL OFFICERS

2-H Corporate Governance: Law and Practice Sarbanes-Oxley § 406

§ Oxley 406 Code of Ethics for Senior Financial Officers (15 USC 7264)

(a) Code of Ethics Disclosure.-- The Commission shall issue rules to require each issuer, together with periodic reports required pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions.

(b) Changes in Codes of Ethics.-- The Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.

(c) Definition.-- In this section, the term "code of ethics" means such standards as are reasonably necessary to promote--

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer;
and

(3) compliance with applicable governmental rules and regulations.

(d) Deadline for Rulemaking.-- The Commission shall--

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules to implement this section, not later than 180 days after that date of enactment.

HISTORY: [July 30, 2002, P.L. 107-204, Title IV, § 406, 116 Stat. 789.]



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Appendix H FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO CODES OF ETHICS
FOR SENIOR FINANCIAL OFFICERS

2-H Corporate Governance: Law and Practice 17 CFR § 229.406

**§ 406 [Regulation S-K Item 406] Code of Ethics (and Instructions) [Implementing Sarbanes-Oxley § 406
Concerning Disclosures for Senior Financial Officers]**

(a) Disclose whether the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the registrant has not adopted such a code of ethics, explain why it has not done so.

(b) For purposes of this Item 406, the term code of ethics means written standards that are reasonably designed to deter wrongdoing and to promote:

(1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;

(3) Compliance with applicable governmental laws, rules and regulations;

(4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and

(5) Accountability for adherence to the code.

(c) The registrant must:

(1) File with the Commission a copy of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its annual report;

(2) Post the text of such code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted such code of ethics on its Internet Web site; or

(3) Undertake in its annual report filed with the Commission to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.

(d) If the registrant intends to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or a waiver from, a provision of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in paragraph (b) of this Item by posting such information on its Internet website, disclose the registrant's Internet address and such intention.

Instructions to Item 406.

1. A registrant may have separate codes of ethics for different types of officers. Furthermore, a code of ethics within the meaning of paragraph (b) of this Item may be a portion of a broader document that addresses additional topics or that applies to more persons than those specified in paragraph (a). In satisfying the requirements of paragraph (c), a registrant need only file, post or provide the portions of a broader document that constitutes a code of ethics as defined in paragraph (b) and that apply to the persons specified in paragraph (a).

2. If a registrant elects to satisfy paragraph (c) of this Item by posting its code of ethics on its website pursuant to paragraph (c)(2), the code of ethics must remain accessible on its Web site for as long as the registrant remains subject to the requirements of this Item and chooses to comply with this Item by posting its code on its Web site pursuant to paragraph (c)(2).

HISTORY: [68 FR 5110, 5127, Jan. 31, 2003; 70 FR 1506, 1594, Jan. 7, 2005.]

AUTHORITY: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee,

77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38, 80av39, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted. Section 229.303 is also issued under secs. 3(a) and 401(a), Pub. L. No. 107-204, 116 Stat. 745. Section 229.307 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745. Section 229.401 is also issued under secs. 3(a) and 407, Pub. L. 107-204, 116 Stat. 745. Section 229.406 is also issued under secs. 3(a) and 406, Pub. L. 107-204, 116 Stat. 745. Section 229.601 is also issued under secs. 3(a) and 406, Pub. L. 107-204, 116 Stat. 745.

NOTES: [EFFECTIVE DATE NOTE: 70 FR 1506, 1594, Jan. 7, 2005, removed instruction 3, effective Mar. 8, 2005. For compliance date information, *see* 70 FR 1506, Jan. 7, 2005.] FORM 8-K Information to be Included in the Report, Item 5.05 [Regarding Amendments to or Waivers of a Provision of Code of Ethics]

Item 5.05 Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics.

(a) Briefly describe the date and nature of any amendment to a provision of the registrant's code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in Item 406(b) of Regulation S-K (*17 CFR 229.406(b)*).

(b) If the registrant has granted a waiver, including an implicit waiver, from a provision of the code of ethics to an officer or person described in paragraph (a) of this Item 5.05, and the waiver relates to one or more of the elements of the code of ethics definition referred to in paragraph (a) of this Item 5.05, briefly describe the nature of the waiver, the name of the person to whom the waiver was granted, and the date of the waiver.

(c) The registrant does not need to provide any information pursuant to this Item 5.05 if it discloses the required information on its Internet website within four business days following the date of the amendment or waiver and the registrant has disclosed in its most recently filed annual report its Internet address and intention to provide disclosure in this manner. If the registrant elects to disclose the information required by this Item 5.05 through its website, such information must remain available on the website for at least a 12-month period. Following the 12-month period, the registrant must retain the information for a period of not less than five years. Upon request, the registrant must furnish to the Commission or its staff a copy of any or all information retained pursuant to this requirement.

Instructions.

1. The registrant does not need to disclose technical, administrative or other non-substantive amendments to its code of ethics.

2. For purposes of this Item 5.05:

(i) The term *waiver* means the approval by the registrant of a material departure from a provision of the code of ethics; and

(ii) The term *implicit waiver* means the registrant's failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer, as defined in Rule 3b-7 (*17 CFR 240.3b-7*) of the registrant.

HISTORY: [33 FR 18995, Dec. 20, 1968; 34 FR 554, Jan. 15, 1969; 65 FR 51716, 51739, Aug. 24, 2000.]

AUTHORITY: 15 U.S.C. 78a *et seq.*, 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350. Section 249.220f is also issued under secs. 3(a), 302, 306(a), 401(a), 401(b), 406 and 407, Pub. L. No. 107-204, 116 Stat. 745. Section 249.240f is also issued under secs. 3(a), 302, 306(a), 401(a), 406 and 407, Pub. L. No. 107-204, 116 Stat. 745.

Section 249.308 is also issued under 15 U.S.C. 80a-29 and 80a-37. Section 249.308a is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 249.308b is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 249.310 is also issued under secs. 3(a), 302, 406 and 407, Pub. L. 107-204, 116 Stat. 745. Section 249.310b is also issued under secs. 3(a), 302, 406 and 407, Pub. L. 107-204, 116 Stat. 745. Section 249.330 is also issued under secs. 3(a), 406, and 407, Pub. L. No. 107-204, 116 Stat. 745. Section 249.331 is also issued under 15 U.S.C. 78j-1, 7202, 7233, 7241, 7264, 7265; and 18 U.S.C. 1350.

NOTES: [EDITORIAL NOTE: Form 8-K revised at 42 FR 4429, Jan. 25, 1977; 53 FR 12931 (1988); 54 FR 9774, 10320 (1989; 57 FR 36501, Aug. 13, 1992; 59 FR 67765, Dec. 30, 1994; 61 FR 54506, 54508, 54509, 54516, Oct. 18, 1996; and amended at 63 FR 9632, 9647, Feb. 25, 1998; and amended at 65 FR 51716, 51739, Aug. 24, 2000; 68 FR 4338, 4359, Jan. 28, 2003; 68 FR 4820, 4833, Jan. 30, 2003; 68 FR 5110, 5128, Jan. 31, 2003; 69 FR 15594, 15619, Mar. 25, 2004, as corrected at 69 FR 48370, 48371, Aug. 10, 2004; 70 FR 1506, 1623, Jan. 7, 2005; 70 FR 42234, 42248, July 21, 2005; 71 FR 53158, 53264, Sept. 8, 2006; 73 FR 934, 980, Jan. 4, 2008.]



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Appendix I FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PROCEDURES FOR
NOMINATION OF CANDIDATES FOR DIRECTOR AND DISCLOSURES RELATING TO NOMINATING
COMMITTEE AND TO RESIGNATION OF DIRECTORS

2-I Corporate Governance: Law and Practice Appendix I.syn

**§ I.syn Synopsis to Appendix I: FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO
PROCEDURES FOR NOMINATION OF CANDIDATES FOR DIRECTOR AND DISCLOSURES RELATING
TO NOMINATING COMMITTEE AND TO RESIGNATION OF DIRECTORS**

17 CFR 240.14a-101, Item 7 [Proxy Statement Disclosure Regarding Directors and Executive Officers]



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Appendix I FEDERAL SECURITIES STATUTES AND REGULATIONS RELATING TO PROCEDURES FOR
NOMINATION OF CANDIDATES FOR DIRECTOR AND DISCLOSURES RELATING TO NOMINATING
COMMITTEE AND TO RESIGNATION OF DIRECTORS

2-I Corporate Governance: Law and Practice 17 CFR 240.14a-101, Item 7

§ 101, Item 7 [Proxy Statement Disclosure Regarding Directors and Executive Officers]

* * * * *

Item 7. Directors and executive officers. If action is to be taken with respect to the election of directors, furnish the following information in tabular form to the extent practicable. If, however, the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation.

(a) The information required by instruction 4 to Item 103 of Regulation S-K (§ 229.103 of this chapter) with respect to directors and executive officers.

(b) The information required by Items 401, 404(a) and (b), 405 and 407(d)(4) and (d)(5) of Regulation S-K (§ 229.401, § 229.404(a) and (b), § 229.405 and § 229.407(d)(4) and (d)(5) of this chapter).

(c) The information required by Item 407(a) of Regulation S-K (§ 229.407 of this chapter).

(d) The information required by Item 407(b), (c)(1), (c)(2), (d)(1), (d)(2), (d)(3), (e)(1), (e)(2), (e)(3) and (f) of Regulation S-K (§ 229.407(b), (c)(1), (c)(2), (d)(1), (d)(2), (d)(3), (e)(1), (e)(2), (e)(3) and (f) of this chapter).

(e) In lieu of the information required by this Item 7, investment companies registered under the Investment

Company Act of 1940 (15 U.S.C. 80a) must furnish the information required by Item 22(b) of this Schedule 14A.

HISTORY: [51 FR 42063, Nov. 20, 1986; 51 FR 45576, Dec. 19, 1986, as amended at 52 FR 21263, June 5, 1987; 52 FR 21937, June 10, 1987; 52 FR 30146, Aug. 13, 1987; 52 FR 48984, Dec. 29, 1987; 53 FR 9767, March 25, 1988; 53 FR 12931, April 20, 1988; 56 FR 7265, Feb. 21, 1991; 57 FR 36495, Aug. 13, 1992; 57 FR 36501, Aug. 13, 1992; 57 FR 48158, Oct. 21, 1992; 57 FR 48293, Oct. 22, 1992; 58 FR 14684, March 18, 1993; 58 FR 26383, May 3, 1993; 58 FR 26519, May 4, 1993; 58 FR 63015, Nov. 29, 1993; 59 FR 52696, Oct. 19, 1994; 59 FR 67764, Dec. 30, 1994; 60 FR 32825, June 23, 1995; 61 FR 49957, 49960, Sept. 24, 1996; 62 FR 6044, 6071, Feb. 10, 1997; 62 FR 36450, 36459, July 8, 1997; 63 FR 13916, 13944, March 23, 1998; 64 FR 1728, 1735, Jan. 12, 1999; 64 FR 27888, 27896, May 21, 1999; 64 FR 61408, 61457, Nov. 10, 1999; 64 FR 73389, 73402, Dec. 30, 1999; 65 FR 65736, 65751, Nov. 2, 2000; 65 FR 76008, 76087, Dec. 5, 2000; 66 FR 3734, 3753, Jan. 16, 2001, as corrected at 66 FR 13234, Mar. 5, 2001; 67 FR 232, 247, Jan. 2, 2002; 68 FR 6006, 6048, Feb. 5, 2003; 68 FR 18788, 18821, Apr. 16, 2003; 68 FR 66992, 67009, Nov. 28, 2003, as corrected at 68 FR 69204, 69221, Dec. 11, 2003; 69 FR 39798, 39807, June 30, 2004; 71 FR 4244, Jan. 26, 2006; 71 FR 53158, 53261, Sept. 8, 2006; 72 FR 4148, 4170, Jan. 29, 2007; 72 FR 42222, 42238, Aug. 1, 2007; 73 FR 934, 977, Jan. 4, 2008.]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350. Sections 240.0-9, 240.0-11, 240.13e-1, 240.13e-100, 240.13e-101 and 240.14d-100 also issued under secs. 12, 13 and 14, 15 U.S.C. 78l, 78m and 78n. Section 240.3a4-1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended. Section 240.3a12-8 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a). Section 240.3a12-10 also issued under 15 U.S.C. 78b and c. Section 240.3a12-9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1)). Sections 240.3a43-1 and 240.3a44-1 also issued under sec. 3; 15 U.S.C. 78c. Section 240.3b-6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.3b-9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78o). Section 240.9b-1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1-4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570-574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78o, 78w(a). Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q). Section 240.12a-7 also issued under 15 U.S.C. 78a *et seq.*, particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1). Sections 240.12b-1 to 240.12b-36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended, 894, 895, as amended; 15 U.S.C. 78c, 78l, 78m, 78o. Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.12b-25 is also issued under 15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37. Section 240.12g-3 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.12g3-2 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L. No. 107-204, 116 Stat. 745. Section 240.13a-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.13e-4, 240.14d-7, 240.14d-10 and 240.14e-1 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(d) and 14(e), 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(d) and 78n(e) and sec. 23(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-23(c). Sections 240.13e-4 to 240.13e-101 also issued under secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 78c(b), 78i(a)(6), 78j(b), 78m(e), 78n(e), 78o(c); sec. 23(c) of the Investment Company Act of 1940; 54 Stat. 825; 15 U.S.C. 80a-23(c). Section 240.13f-2(T) also issued under sec. 13(f)(1) (15 U.S.C. 78m(f)(1)). Sections 240.14a-1, 240.14a-3, 240.14a-13, 240.14b-1, 240.14b-2, 240.14c-1, and 240.14c-7 also issued under secs. 12, 15 U.S.C. 78l, and 14, Pub. L. 99-222, 99 Stat. 1737, 15 U.S.C. 78n. Sections 240.14a-3, 240.14a-13, 240.14b-1 and 240.14c-7 also issued under secs.

12, 14 and 17, 15 U.S.C. 781, 78n and 78g. Sections 240.14c-1 to 240.14c-101 also issued under sec. 14, 48 Stat. 895; 15 U.S.C. 78n. Section 240.14d-1 is also issued under 15 U.S.C. 77g, 77j, 77s(a), 77ttt(a), 79t, 80a-37. Section 240.14e-2 is also issued under 15 U.S.C. 77g, 77h, 77s(a), 77sss, 79t, 80a-37(a). Section 240.14e-4 also issued under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly sections 3(b), 10(a), 10(b), 14(e), 15(c), and 23(a) of the Exchange Act (15 U.S.C. 78c(b), 78j(a), 78j(b), 78n(e), 78o(c), and 78w(a)). Section 240.15a-6, also issued under secs. 3, 10, 15, and 17, 15 U.S.C. 78c, 78j, 78o, and 78q. Sections 240.15b1-3 and 240.15b2-1 also issued under 15 U.S.C. 78o, 78q. Section 240.15b2-2 also issued under secs. 3, 15; 15 U.S.C. 78c, 78o. Sections 240.15b10-1 to 240.15b10-9 also issued under secs. 15, 17, 48 Stat. 895, 897, sec. 203, 49 Stat. 704, secs. 4, 8, 49 Stat. 1379, sec. 5, 52 Stat. 1076, sec. 6, 78 Stat. 570; 15 U.S.C. 78o, 78q, 12 U.S.C. 241 nt. Section 240.15c2-6, also issued under secs. 3, 10, and 15, 15 U.S.C. 78c, 78j, and 78o. Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a). Section 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q. Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3). Section 240.15d-5 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a). Section 240.15d-10 is also issued under 15 U.S.C. 80a-20(a) and 80a-37(a), and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-11 is also issued under secs. 3 (a) and 306(a), Pub L. 107-204, 116 Stat. 745. Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Sections 240.15Ca1-1, 240.15Ca2-1, 240.15Ca2-2, 240.15Ca2-3, 240.15Ca2-4, 240.15Ca2-5, 240.15Cc1-1 also issued under secs. 3, 15C; 15 U.S.C. 78c, 78o-5. Section 240.17a-3 also issued under secs. 2, 17, 23a, 48 Stat. 897, as amended; 15 U.S.C. 78d-1, 78d-2, 78q; secs. 12, 14, 17, 23(a), 48 Stat. 892, 895, 897, 901; secs. 1, 4, 8, 49 Stat. 1375, 1379; sec. 203(a), 49 Stat. 704; sec. 5, 52 Stat. 1076; sec. 202, 68 Stat. 686; secs. 3, 5, 10, 78 Stat. 565-568, 569, 570, 580; secs. 1, 3, 82 Stat. 454, 455; secs. 28(c), 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 14, 18, 89 Stat. 117, 118, 137, 155; 15 U.S.C. 78l, 78n, 78q, 78w(a). Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w). Section 240.17a-23 also issued under 15 U.S.C. 78b, 78c, 78q, and 78w(a). Section 240.17f-1 is also authorized under sections 2, 17 and 17A, 48 Stat. 891, 89 Stat. 137, 141 (15 U.S.C. 78b, 78q, 78q-1). Section 240.17h-1T also issued under 15 U.S.C. 78q. Sections 240.17Ac2-1(c) and 240.17Ac2-2 also issued under secs. 17, 17A and 23(a); 48 Stat. 897, as amended, 89 Stat. 137, 141 and 48 Stat. 901 (15 U.S.C. 78q, 78q-1, 78w(a)). Section 240.17Ad-1 is also issued under secs. 2, 17, 17A and 23(a); 48 Stat. 841 as amended, 48 Stat. 897, as amended, 89 Stat. 137, 141, and 48 Stat. 901 (15 U.S.C. 78b, 78q, 78q-1, 78w). Sections 240.17Ad-5 and 240.17Ad-10 are also issued under secs. 3 and 17A; 48 Stat. 882, as amended, and 89 Stat. (15 U.S.C. 78c and 78q-1). Section 240.17Ad-7 also issued under 15 U.S.C. 78b, 78q, and 78q-1. Sections 240.19c-4 also issued under secs. 6, 11A, 14, 15A, 19 and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3, and 78s). Section 240.19c-5 also issued under Sections 6, 11A, and 19 of the Securities Exchange Act of 1934, 48 Stat. 885, as amended, 89 Stat. 111, as amended, and 48 Stat. 898, as amended, 15 U.S.C. 78f, 78k-1, and 78s. Section 240.31-1 is also issued under sec. 31, 48 Stat. 904, as amended (15 U.S.C. 78ee).

NOTES: [EFFECTIVE DATE NOTE: 71 FR 53158, 53261, Sept. 8, 2006, amended this section, effective Nov. 7, 2006. For compliance date information, *see* 71 FR 53158, Sept. 8, 2006; 72 FR 4148, 4170, Jan. 29, 2007, amended this section, effective Mar. 30, 2007. For compliance date information, *see* 72 FR 4148, Jan. 29, 2007; 72 FR 42222, 42238, Aug. 1, 2007, amended Item 4(a)(3), effective Jan. 1, 2008. For compliance date information, *see* 72 FR 42222, Aug. 1, 2007; 73 FR 934, 977, Jan. 4, 2008, amended this section, effective Feb. 4, 2008. For compliance date information, *see* 73 FR 934, Jan. 4, 2008.] Form 8-K Item 5.02 and Instructions thereto [Disclosure on Form 8-K, and Related Procedures, Regarding Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers]

* * * * *

Item 5.02 Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers

(a)(1) If a director has resigned or refuses to stand for re-election to the board of directors since the date of the last

annual meeting of shareholders because of a disagreement with the registrant, known to an executive officer of the registrant, as defined in *17 CFR 240.3b-7*, on any matter relating to the registrant's operations, policies or practices, or if a director has been removed for cause from the board of directors, disclose the following information:

- (i) the date of such resignation, refusal to stand for re-election or removal;
- (ii) any positions held by the director on any committee of the board of directors at the time of the director's resignation, refusal to stand for re-election or removal; and
- (iii) a brief description of the circumstances representing the disagreement that the registrant believes caused, in whole or in part, the director's resignation, refusal to stand for re-election or removal.

(2) If the director has furnished the registrant with any written correspondence concerning the circumstances surrounding his or her resignation, refusal or removal, the registrant shall file a copy of the document as an exhibit to the report on Form 8-K.

(3) The registrant also must:

(i) provide the director with a copy of the disclosures it is making in response to this Item 5.02 no later than the day the registrant file the disclosures with the Commission;

(ii) provide the director with the opportunity to furnish the registrant as promptly as possible with a letter addressed to the registrant stating whether he or she agrees with the statements made by the registrant in response to this Item 5.02 and, if not, stating the respects in which he or she does not agree; and

(iii) file any letter received by the registrant from the director with the Commission as an exhibit by an amendment to the previously filed Form 8-K within two business days after receipt by the registrant.

(b) If the registrant's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, or any named executive officer, retires, resigns or is terminated from that position, or if a director retires, resigns, is removed, or refuses to stand for re-election (except in circumstances described in paragraph (a) of this Item 5.02), disclose the fact that the event has occurred and the date of the event.

(c) If the registrant appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or person performing similar functions, disclose the following information with respect to the newly appointed officer:

(1) the name and position of the newly appointed officer and the date of the appointment;

(2) the information required by Items 401(b), *17 CFR 229.401(b), (d), (e)* and Item 404(a) of Regulation S-K (*17 CFR 229.401(b), (d), (e)* and *229.404(a)*), or, in the case of a small business issuer, Items 401(a)(4), (a)(5), (c), and Item 404(a) of Regulation S-B (*17 CFR 228.401(a)(4), (a)(5), (c), and 228.404(a)*), respectively); and

(3) a brief description of any material plan, contract or arrangement (whether or not written) to which a covered officer is a party or in which he or she participates that is entered into or material amendment in connection with the triggering event or any grant or award to any such covered person or modification thereto, under any such plan, contract or arrangement in connection with any such event.

Instruction to paragraph (c).

If the registrant intends to make a public announcement of the appointment other than by means of a report on Form 8-K, the registrant may delay filing the Form 8-K containing the disclosures required by this Item 5.02(c) until the day on which the registrant otherwise makes public announcement of the appointment of such officer.

(d) If the registrant elects a new director, except by a vote of security holders at an annual meeting or special meeting convened for such purpose, disclose the following information:

(1) the name of the newly elected director and the date of election;

(2) a brief description of any arrangement or understanding between the new director and any other persons, naming such persons, pursuant to which such director was selected as a director;

(3) the committees of the board of directors to which the new director has been, or at the time of this disclosure is expected to be, named; and

(4) the information required by Item 404(a) of Regulation S-K (17 CFR 229.404(a)) *17 CFR 229.404(a)*.

(5) a brief description of any material plan, contract or arrangement (whether or not written) to which the director is a party or in which he or she participates that is entered into or material amendment in connection with the triggering event or any grant or award to any such covered person or modification thereto, under any such plan, contract or arrangement in connection with any such event.

(e) If the registrant enters into, adopts, or otherwise commences a material compensatory plan, contract or arrangement (whether or not written), as to which the registrant's principal executive officer, principal financial officer, or a named executive officer participates or is a party, or such compensatory plan, contract or arrangement is materially amended or modified, or a material grant or award under any such plan, contract or arrangement to any such person is made or materially modified, then the registrant shall provide a brief description of the terms and conditions of the plan, contract or arrangement and the amounts payable to the officer thereunder.

Instructions to paragraph (e).

1. Disclosure under this Item 5.02(e) shall be required whether or not the specified event is in connection with events otherwise triggering disclosure pursuant to this Item 5.02.

2. Grants or awards (or modifications thereto) made pursuant to a plan, contract or arrangement (whether involving cash or equity), that are materially consistent with the previously disclosed terms of such plan, contract or arrangement, need not be disclosed under this Item 5.02(e), provided the registrant has previously disclosed such terms and the grant, award or modification is disclosed when Item 402 of Regulation S-K (17 CFR 229.402) requires such disclosure.

(f) If the salary or bonus of a named executive officer cannot be calculated as of the most recent practicable date and is omitted from the Summary Compensation Table as specified in Instruction 1 to Item 402(c)(2)(iii) and (iv) of Regulation S-K, disclose the appropriate information under this Item 5.02(f) when there is a payment, grant, award, decision or other occurrence as a result of which such amounts become calculable in whole or in part. Disclosure under this Item 5.02(f) shall include a new total compensation figure for the named executive officer, using the new salary or bonus information to recalculate the information that was previously provided with respect to the named executive officer in the registrant's Summary Compensation Table for which the salary and bonus information was omitted in reliance on Instruction 1 to Item 402(c)(2)(iii) and (iv) of Regulation S-K (17 CFR 229.402(c)(2)(iii) and (iv)).

Instructions to Item 5.02.

1. The disclosure requirements of this Item 5.02 do not apply to a registrant that is a wholly-owned subsidiary of an issuer with a class of securities registered under Section 12 of the Exchange Act (*15 U.S.C. 78l*), or that is required to file reports under Section 15(d) of the Exchange Act (*15 U.S.C. 78o(d)*).
2. To the extent that any information called for in Item 5.02(c)(3) or Item 5.02(d)(3) or Item 5.02(d)(4) is not determined or is unavailable at the time of the required filing, the registrant shall include a statement this effect in the filing and then must file an amendment to its Form 8-K filing under this Item 5.02 containing such information within four business days after the information is determined or becomes available.
3. The registrant need not provide information with respect to plans, contracts, and arrangements to the extent they do not discriminate in scope, terms or operation, in favor of executive officers or directors of the registrant and that are available generally to all salaried employees.
4. For purposes of this Item, the term "named executive officer" shall refer to those executive officers for whom disclosure was required in the registrant's most recent filing with the Commission under the Securities Act (15 U.S.C. 77a *et seq.*) or Exchange Act (15 U.S.C. 78a *et seq.*) that required disclosure pursuant to Item 402(c) of Regulation S-K (17 CFR 229.402(c)).

HISTORY: [33 FR 18995, Dec. 20, 1968; 34 FR 554, Jan. 15, 1969; 65 FR 51716, 51739, Aug. 24, 2000.]

AUTHORITY: 15 U.S.C. 78a *et seq.*, 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350. Section 249.220f is also issued under secs. 3(a), 302, 306(a), 401(a), 401(b), 406 and 407, Pub. L. No. 107-204, 116 Stat. 745. Section 249.240f is also issued under secs. 3(a), 302, 306(a), 401(a), 406 and 407, Pub. L. No. 107-204, 116 Stat. 745. Section 249.308 is also issued under 15 U.S.C. 80a-29 and 80a-37. Section 249.308a is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 249.308b is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745. Section 249.310 is also issued under secs. 3(a), 302, 406 and 407, Pub. L. 107-204, 116 Stat. 745. Section 249.310b is also issued under secs. 3(a), 302, 406 and 407, Pub. L. 107-204, 116 Stat. 745. Section 249.330 is also issued under secs. 3(a), 406, and 407, Pub. L. No. 107-204, 116 Stat. 745. Section 249.331 is also issued under 15 U.S.C. 78j-1, 7202, 7233, 7241, 7264, 7265; and 18 U.S.C. 1350.

NOTES: [EDITORIAL NOTE: Form 8-K revised at 42 FR 4429, Jan. 25, 1977; 53 FR 12931 (1988); 54 FR 9774, 10320 (1989); 57 FR 36501, Aug. 13, 1992; 59 FR 67765, Dec. 30, 1994; 61 FR 54506, 54508, 54509, 54516, Oct. 18, 1996; and amended at 63 FR 9632, 9647, Feb. 25, 1998; and amended at 65 FR 51716, 51739, Aug. 24, 2000; 68 FR 4338, 4359, Jan. 28, 2003; 68 FR 4820, 4833, Jan. 30, 2003; 68 FR 5110, 5128, Jan. 31, 2003; 69 FR 15594, 15619, Mar. 25, 2004, as corrected at 69 FR 48370, 48371, Aug. 10, 2004; 70 FR 1506, 1623, Jan. 7, 2005; 70 FR 42234, 42248, July 21, 2005; 71 FR 53158, 53264, Sept. 8, 2006; 73 FR 934, 980, Jan. 4, 2008.]