

**Some Thoughts for Boards of Directors in 2010**

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### **I. INTRODUCTION**

Never before in the history of American business has the role of the corporate director been more important or more challenging. Boards today must navigate a tremendously difficult business environment featuring intense competition from foreign manufacturers, weak consumer confidence, growing unemployment, volatility in financial and commodity markets and a host of other complex challenges. At the same time, directors are currently undergoing intense public and political scrutiny of their basic role and functioning at the helm of public companies. As we begin to emerge from the worst recession since the Great Depression, the search for root causes of the economic crisis and second-guessing of corporate decisions has generated a multitude of corporate governance reform proposals that seek to shift decision-making authority from boards to institutional shareholders and shareholder activists. Despite the stated intention of these initiatives, this shift will impede the ability of boards to resist pressures for short-term gain and tie their hands at a time when the need for effective board leadership is particularly acute.

While corporate governance activists have been agitating for a number of years—in many cases with substantial success—these efforts have exponentially multiplied and accelerated. Reform proposals have recently been advanced across a full spectrum of legal avenues, including new and proposed federal legislation and regulations, SEC rule-making, amendments to state corporation laws and stock exchange rules, court decisions, policy recommendations from non-governmental organizations and shareholder proposals. Initiatives range from advocating enhanced disclosure obligations to calling for more fundamental changes in the structure and authority of the board, and address topics that include shareholder proxy access, majority voting, discretionary broker voting in director elections, risk management, say-on-pay and other executive compensation policies, the separation of chairman and CEO roles, annual director elections and disclosures about the company's board and leadership structure.

To be sure, the search for lessons that may be gleaned from the financial crisis is commendable, and regulatory and other reforms are needed. In particular, the undue focus on short-term gains at the expense of long-term shareholder value has been widely cited as a factor that contributed to the destabilization of the financial system. However, while many reform agendas purport to embrace this goal, they advocate changes that are premised on the fundamentally misguided assumption that empowering shareholders is the surest way to fix the system. In reality, the notion of shareholders as relatively disempowered individuals who are benignly seeking to ensure the best interests of corporations is simplistic and outdated. The shareholder base of most large public companies today consists of powerful, sophisticated hedge funds, politically motivated union and public pension funds, and other large institutional shareholders with diverse investment time horizons and objectives. The ability of these institutions to influence board decisions has grown substantially in recent years and has more often been applied to increase, rather than moderate, risk-taking by companies to produce short-term results.

In many respects, the hallmark of recent reform efforts has been a knee-jerk embrace of the shareholder rights mantra at the expense of a more pragmatic, empirically grounded approach to reform. For example, the proposed Shareholder Bill of Rights Act of 2009 cites “a

widespread failure of corporate governance” as one of “the central causes of the financial and economic crises that the United States faces today” and would enhance the ability of shareholders to override boards of directors and to compel companies to manage for short-term gains.

Given the ongoing seismic shift in the corporate governance landscape, there has been a renewed focus by directors on the proper role and functioning of boards. A study published in September 2009 by Professor Jay W. Lorsch and other members of the Harvard Business School’s Corporate Governance Initiative (accessible at this link: [Perspectives from the Boardroom](#)) suggests, based on interviews with 45 directors of public companies, that “the economic shock of 2008 appears to have caused many directors to reconsider what their boards had been doing and to question whether they could or should be acting differently.” The study reports a strong consensus among the directors that the key to improving board performance is not government action, but rather action on the part of each board. Directors indicated that matters such as how directors work together and with management to oversee the company could not be effectively regulated by government. Instead, the prevailing belief was that each board should develop structures, processes and practices that are tailored to the company’s needs. The study concludes that many directors today are keenly interested in obtaining better clarity and a more precise understanding of the proper role of the board, and view this as essential to enhancing board effectiveness.

Our own experience suggests that most boards make a significant effort to be thoughtful about their role and pay a great deal of attention to processes and practices. But, it is important to recognize that periodic reviews of board functions and procedures, particularly in light of the current reform proposals, are necessary. There is clearly no “one-size-fits-all” approach to crafting a successful modus operandi for any given board, and board procedures should be fine-tuned to reflect the specific circumstances and challenges facing the company. In principle, however, core board functions should include the following:

**1. CEO Succession Planning**

There is no job that is more important for the board than selecting the company’s CEO and planning for his or her succession. The board bears the ultimate responsibility for this task, and a protracted delay in finding a suitable replacement can detract significantly from the stability of the company and its ability to react quickly and decisively to evolving challenges. The integrity and dedication of the CEO is vital to enabling the board to meet all of its responsibilities and, in large measure, the fate of each of the board and the CEO is in the hands of the other.

**2. Long-Term Strategy**

Approval of the corporation’s long-term strategy is a key board function and an integral part of its role as business and strategic advisor to management. Strategy should be formulated initially by management and then developed fully in an interactive dialogue with the board, with reassessments as economic conditions develop. Pressures to focus unduly on short-term stock price performance present real challenges to maintaining long-term growth strategies, and the board’s ability to craft a strategic vision and manage these pressures can be essential to the overall best interests of the company. In addition, the board should consider all of the com-

pany's constituencies—including shareholders, employees, creditors, customers and local communities—in determining how best to position the company for long-term health, growth and value, which will inure to the benefit of each of these constituencies.

### **3. Monitoring Performance and Compliance**

While the corporation laws literally provide that the business of the corporation is to be managed by or under the direction of the board of directors, it is clear that the board's function is not actually to manage, but rather to oversee the management of the company. The role of the board as strategic and business advisor to management as noted above is part of this oversight. The other part is monitoring the performance of the company and management, including monitoring customary economic metrics as well as compliance with laws and regulations. The board does not have a duty to ferret out compliance problems, but it is required to determine that the corporation has implemented appropriate monitoring systems, and it must take appropriate action when it becomes aware of a problem and believes that management is not properly dealing with it. The board should monitor government relations policies and practices and matters affecting the public persona and reputation of the company, as well as the "tone at the top" of the company, which shapes corporate culture and permeates the company's relationships with its constituents. The board must be sensitive to "red flags" and "yellow flags" and should investigate as warranted.

### **4. Executive Compensation**

Executive compensation policies are currently subject to intense political and public scrutiny, and there has been a proliferation of reform proposals seeking, among other things, non-binding shareholder votes to approve executive compensation and golden parachutes, prohibitions on severance payments to officers terminated for poor performance, strict independence standards for compensation committee members and compensation consultants, "clawbacks" of unearned performance-based pay, and increased disclosure requirements relating to compensation policies and the relationship of such policies to risk management. While it is necessary to bear in mind both pay-for-performance and risk management principles, directors should not lose sight of the underlying goal of executive compensation—namely, to attract and retain qualified individuals who will contribute to the long-term success of the company. A compensation committee that follows normal procedures and has the advice of legal counsel and an independent consultant should not fear being second-guessed by the courts, which continue to respect compensation decisions so long as directors act on an informed basis, in good faith and not in their personal self-interest.

### **5. Risk Management**

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

corporate risk management is neither an impediment to the conduct of business nor a mere supplement to the company's overall compliance program, but is instead an integral component of the company's corporate strategy, culture and value-generation process. Where board committees are responsible for overseeing different areas of risk management, the work of these committees should be coordinated in a coherent manner so that the entire board can be satisfied as to the adequacy of the risk oversight function and the company's overall risk exposures are understood.

## **6. Shareholder and Constituent Relations**

Shareholder relations have become increasingly complicated as a result of activist trends, and each year they require greater attention by the board. The same is true for relations with creditors, employees, suppliers, customers and communities. While the board should ensure that the company has an effective shareholder relations program, management should generally be the primary caretaker of shareholder and constituent relationships. However, where shareholders request direct communications with the board, it may be desirable for directors, in appropriate circumstances and following consultation with management, to accommodate such requests. In any event, management and the directors should speak with a unified voice to avoid confusion in the company's public posture, and they should work together toward the shared goal of avoiding contentious relationships with shareholders and other constituents.

## **7. Effective Functioning of the Board**

The board should take a pragmatic approach to formulating procedures that will enable it to function effectively. As discussed in the Lorsch study noted above, some of the considerations that arise when trying to calibrate the activities and structure of the board include the proper allocation of decision-making responsibility between the board and management, the need to cultivate constructive relationships and open dialogue with management, the scope of information that the board should receive from management, and the time constraints and other practical limitations on directors' understanding and depth of knowledge of the company's business.

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This memorandum sets forth some of the significant corporate governance issues that boards face in the coming year, as well as some practical considerations to bear in mind. In order to avoid an overemphasis on process and at the same time effectively discharge the board's duties to monitor and supervise the business of the corporation, it is necessary to identify the principal matters meriting the board's focus and create a reasonable program to deal with them. Some are perennial themes that remain relevant and deserve to be reemphasized from year to year, whereas others have recently come into particular focus.

## **II. SOME KEY ISSUES FACING BOARDS IN 2010**

### **1. Executive Compensation**

This past year, executive compensation has been a remarkably high-profile, politically charged topic—in short, a lightning rod for controversy. Terms such as “pay for performance,” “golden parachutes” and “clawbacks” have become engrained in the lexicon of the

financial crisis and ensuing public debate. While much of the attention has been focused on executive compensation that is deemed excessive in amount, there has also been a critical assessment of the interplay among compensation policies, corporate risk-taking and short-termism. For example, world leaders at the G-20 summit this past September agreed in principle to reform executive compensation standards with the goal of reducing excessive risk-seeking, and a declaration issued after the London summit in April endorsed a set of compensation principles for significant financial institutions developed to “ensure compensation structures are consistent with firms’ long-term goals and prudent risk taking.”

Many of the reforms that have been adopted so far target the pay practices of banks and other financial institutions. For example, the Federal Reserve has recently issued proposed guidance that indicates that all banking organizations are now expected to evaluate incentive compensation and related risk management and governance processes, and address any deficiencies that are inconsistent with safety and soundness. The guidance cites certain core principles, such as the principle that incentive compensation should “be supported by strong corporate governance, including active and effective oversight” by the board of directors. It also expressly calls for the involvement of functions such as compliance, internal audit and risk management in the incentive compensation process. In conjunction with this proposed guidance, the Federal Reserve announced that it will review incentive compensation of banking organizations as part of its risk-focused examination process and, for 28 “large, complex” banking organizations, it will conduct a special horizontal review of incentive compensation practices.

Many aspects of these bank-related reforms have now been incorporated into initiatives that extend well beyond the banking sector and are impacting the compensation practices of all public companies. In June, the Department of Treasury, working with the Federal Reserve and the SEC, issued a statement outlining various compensation reform principles that it hopes to use over time to develop legislation and SEC rules for all public companies, including say-on-pay legislation and enhanced independence standards for compensation committee members. Several pieces of legislation have been proposed and are pending at various stages of the Congressional pipeline—including the Shareholder Bill of Rights Act of 2009, the Shareholder Empowerment Act of 2009, the Investor Protection Act of 2009, the Corporate and Financial Institution Compensation Fairness Act of 2009, the Corporate Governance Reform Act of 2009, the Excessive Pay Shareholder Approval Act and the Restoring American Financial Stability Act of 2009. These proposals would require, among other things, a non-binding say-on-pay vote on executive compensation packages and golden parachute arrangements, approval by 60 percent of a company’s shareholders of compensation packages in excess of 100 times the average compensation of the company’s employees, mandatory clawback provisions, restrictions on severance payments, disclosures regarding compensation targets and the use of compensation consultants and independence standards for compensation consultants.

In addition, new rules proposed by the SEC this past summer would require the CD&A section of company proxy statements to include an analysis of the relationship between employee compensation policies and risk management, to the extent that risks arising from compensation policies or practices might have a material effect on the company. Examples of situations that may require particular attention in the CD&A include compensation practices for business units that carry a significant portion of the company’s risk profile or that are structured significantly differently from the compensation practices applicable to other business units within

the company. The SEC has also proposed detailed disclosure obligations regarding compensation consultants who advise on executive or director compensation and provide other services to the company. The SEC has indicated that, if adopted, it expects these rules to be effective for the 2010 proxy season.

In anticipation of impending reforms, many U.S. companies have begun to implement changes to their compensation practices. In September, citing the need to restore public trust in the ability of boards to oversee executive compensation, the Conference Board issued a set of compensation principles—endorsed by a number of major companies—that call for ensuring the link between pay and performance, adopting best practices, avoiding certain controversial practices absent special justification, demonstrating effective board-level oversight of executive pay and ensuring transparency and appropriate dialogue between boards and shareholders regarding executive compensation. In a similar vein, a group of approximately 100 independent directors has started the Independent Directors Executive Compensation Project to develop compensation principles focused on board accountability, aligning pay with performance, fairness, transparency and objectivity. Several companies have also adopted say-on-pay policies—for example, Microsoft Corp. agreed to give shareholders a say-on-pay vote every three years, Prudential Financial has agreed to a biennial vote and Verizon Communications, Intel, AFLAC, Apple and others have adopted an annual vote policy.

In this environment, boards and compensation committees should review compensation policies with great care, being mindful of pay-for-performance principles while also seeking to avoid policies that will encourage excessive risk-taking. Directors should also bear in mind the heightened sensitivity to pay packages that could be deemed “excessive” given the new post-crisis emphasis on financial restraint and prudence. For example, earlier this year the Delaware Court of Chancery refused to dismiss a claim that the \$68 million package of bonus, salary, accumulated holdings and certain perks awarded to Citigroup’s departing CEO constituted a waste of corporate assets, and found reasonable doubt as to whether this package was beyond the “outer limit.”

At the same time, the board and compensation committee should not lose sight of the underlying goal of executive compensation—namely to attract and retain qualified individuals. Structuring compensation arrangements that meet all of these objectives is increasingly complicated in an environment that features lower equity values and challenging, volatile macroeconomic forces. However, a compensation committee that follows normal procedures and has the advice of legal counsel and an independent consultant should not fear being second-guessed by the courts, which continue to respect compensation decisions so long as the directors act on an informed basis, in good faith and not in their personal self-interest. In the final analysis, the ability to recruit and retain world-class executives is essential to the long-term success of the corporation.

## **2. CEO Succession Planning**

CEOs and senior management have been under tremendous pressure from shareholders, employees, customers and other constituencies to manage difficult market conditions, and not surprisingly, continuity of executive leadership throughout the economic crisis has increasingly been the exception rather than the norm. One consulting firm, Challenger, Gray and

Christmas, Inc., has estimated that in 2008, approximately 1,484 public companies had CEO turnovers by the end of that year, which was a record number for the last decade. In this environment, the board's role in selecting and evaluating the CEO and senior leadership, and planning for their succession, is a critical element of the company's strategic plan and should be approached with an "expect the unexpected" mindset. A leadership gap can undermine public confidence in the future of the company as well as the company's ability to navigate immediate and evolving challenges.

Several surveys have reported that directors believe CEO succession planning remains an area that merits greater focus by their boards. For example, only 53 percent of the directors surveyed last year for a report by PricewaterhouseCoopers believed they were effective at completing a management succession plan, and 41 percent indicated they would like to spend more time in this area. Another survey published by the National Association of Corporate Directors indicated that 51 percent of the directors rated their boards as less than effective in CEO succession planning, and only 11 percent reported their boards were highly effective in this area.

Shareholder activists have increasingly focused on the issue of succession planning. The Laborers' International Union of America, for example, has submitted a succession planning proposal to Whole Foods Market and has indicated it intends to file similar proposals at other companies. Although the SEC staff has generally allowed companies to omit proposals seeking CEO succession planning reports on the grounds that they relate to ordinary business matters, the SEC issued guidance in November 2009 indicating that "CEO succession planning raises a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matter of managing the workforce," and accordingly, that going forward it will take the view that a company generally may not rely on the exclusionary rule for "ordinary business operations" to exclude a shareholder proposal that focuses on CEO succession planning.

In fulfilling its evaluation and succession planning functions, the board should be satisfied that there is a leadership development program in place to cultivate potential CEOs and senior executives. Succession plans should be reviewed on a regular rather than reactive basis, and the process should be tailored to the specific circumstances of the company. At the end of the day, the integrity, dedication and competence of the CEO is vital to enabling the board to meet all of its responsibilities and, in large measure, the fate of each of the board and the CEO is in the hands of the other.

### **3. Risk Management**

The global economic crisis has vividly demonstrated the importance of comprehensive risk management, as well as the grave repercussions for both companies and the economy more broadly when there are blind spots in evaluating and managing risks. In large measure, these blind spots were system-wide and resulted from the convergence of several long-term trends—including the proliferation of highly complex financial products, a ballooning credit bubble with increasing amounts and types of leverage, inadequate understanding of both embedded risks and limits on diversification, and various macroeconomic imbalances. While many of these factors were well beyond the control of any given board of directors, some companies did a better job than others in anticipating, identifying and managing their risk profiles and responding to these challenges.

Several reform initiatives are underway that aim to strengthen corporate risk management. There has been a strong focus on the interplay between compensation policies and corporate risk-taking, as illustrated by the SEC's proposed CD&A amendments to require disclosures regarding the relationship between employee compensation policies and risk management. In addition, the SEC has announced its intention to focus on risk oversight mechanisms and has created a new Division of Risk, Strategy, and Financial Innovation to help identify developing risks and trends in the financial markets. The SEC has also noted "widespread recognition that the board's role in the oversight of a company's management of risk is a significant policy matter regarding the governance of a corporation," and accordingly has indicated a willingness to allow shareholder proposals focused on this board function to be included in company proxy materials. Risk management reforms have also been proposed as part of legislative initiatives—for example, the Shareholder Bill of Rights Act would require each public company board to establish a separate risk committee, composed entirely of independent directors, to be responsible for the establishment and evaluation of risk management practices. Similarly, the proposed Restoring American Financial Stability Act would require certain financial institutions to establish such a committee to supervise enterprise-wide risk management practices. The risk committee would be required to include at least one risk management expert with experience in identifying, assessing and managing risk exposures.

At the same time, many directors have been reassessing their role and function in their companies' risk management structures. The board's role is one of informed oversight rather than direct management of risk, and it cannot and should not be involved in the day-to-day risk management activities. Directors should instead satisfy themselves that the risk management processes designed and implemented by executives and risk managers are adapted to the board's corporate strategy and are functioning as directed, and that necessary steps are taken to foster a culture of risk-adjusted decision-making throughout the organization. A company's risk management system should function to bring to the board's attention the company's most material risks and permit the board to understand and evaluate how those risks interrelate, how they affect the company, and how management addresses those risks. Through its oversight role, the board can send a message to the company's management and employees that comprehensive corporate risk management is neither an impediment to the conduct of business nor a mere supplement to the company's overall compliance program, but is instead an integral component of the company's corporate strategy, culture and value-generation process.

The board should consider the best organizational structure to give risk oversight sufficient attention at the board level. In some companies, this may include creating a separate risk management committee or subcommittee. In others, it may be most effective to schedule the review of risk management as a dedicated and periodic agenda item for an existing committee such as the audit committee, coupled with periodic review at the full board level. Risk management can also be allocated among existing committees as long as the committees coordinate their risk management efforts and share information appropriately with each other and with the full board. While no "one size fits all," it is important that risk management be a priority and that a system for risk oversight appropriate to the company be in place.

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

#### **4. Long-Term Value v. Short-Term Gain**

In searching for lessons from the economic crisis, considerable attention has been focused on ways in which pressures to produce short-term gains spurred excessive risk-taking, over-leveraging and short-sighted business decisions. One of the primary talking points used in connection with recent reform efforts has been the importance of restoring long-term value creation. At the same time, unions, public pension funds and other shareholder activists have taken up this theme to promote their shareholder empowerment agenda, which extols shareholder rights both as an end in itself as well as a means of instilling greater accountability into governance structures. These activists have argued that strengthening shareholder rights will promote long-term value creation, and they have been successful in inserting this agenda into a number of the legislative proposals introduced in response to the economic crisis. In fact, however, there is no evidence that the shareholder empowerment agenda will accomplish this goal. To the contrary, shifting more power to institutional shareholders is likely to do just the opposite—as evidenced by numerous very real examples of hedge funds and other special interest shareholders demanding extraordinary dividends, diversions of capital expenditures to fund equity buy-backs, divestitures of businesses and other corporate actions designed to produce immediate gains at the risk of the company’s long-term viability.

The overriding emphasis on shareholder rights is skewing the process of thinking about how best to promote sustainable, long-term growth. The objective of hedge funds and other activist shareholders is to execute trading strategies, take advantage of market volatility and otherwise maximize their returns based on investment time horizons that, in some cases, are a matter of days or even minutes. Given this reality, it is illogical to assume that reforms aimed at increasing the ability of such shareholders to directly influence the management of public companies will promote a more long-term, holistic corporate outlook.

Furthermore, while shareholders have sustained tremendous financial losses as a result of the economic crisis, they are not the only victims. Many other constituencies—including employees, creditors, suppliers and other business partners, as well as local communities—have been negatively impacted by the recession and deserve to be taken into account in the regulatory response. In contrast to directors who are bound by legal fiduciary obligations to act in the best interests of corporations and shareholders as a whole, hedge funds and other investors are by their nature less willing and able to consider either other shareholders or non-shareholder constituencies. This is the key advantage of the director-centric model of corporate governance: a strong, impartial board is best situated to resist pressures for short-term gains and balance competing interests to promote long-term value.

In short, what is needed is not a heavy-handed tipping of the scales in favor of shareholder rights, but rather a comprehensive assessment and recalibration of appropriate governance structures and regulations. Earlier this year, for example, the Aspen Institute Business & Society Program’s Corporate Values Strategy Group issued a proposal to overcome short-termism and to restore a “responsible and balanced approach to business and investment.”

In today’s environment, directors must be vigilant and proactive in seeking to balance short-term pressures against long-term goals, and must critically evaluate activist agendas—withstanding the threat of proxy contests, withhold-the-vote campaigns and other pressure

tactics—to determine for themselves what will further the best interests of the company and its constituents. The company’s long-term strategy should be formulated initially by management and then developed fully in an interactive dialogue with the board, with reassessments as economic conditions develop.

## **5. Takeover Defense**

A convergence of several factors—including recovering equity values, loosening of credit markets, expense reduction and stockpiling of cash by some companies as well as factors driving consolidation trends—has led some observers to suggest that we may be poised for a rebound in M&A activity. As the economy begins the slow path to recovery and market conditions stabilize, some companies will find they have recovered enough to pursue acquisition targets, while those that lag behind may be targeted by the acquirors. Hostile activity may be particularly prevalent; indeed, a recent study issued by Citigroup notes that historically, “hostile M&A tends to rebound sharply after equity market collapses and economic recessions, driven by a desire on the part of the raider to capitalize on the relatively depressed equity value of the target.”

Many companies may find they are vulnerable as a result of the sustained attack by shareholder activists and proxy voting advisors on takeover protections in recent years. Moreover, many of the pending governance reforms seek to enhance the influence of shareholders over boards in ways that will prevent companies from adopting defensive measures in response to a takeover bid. For example, the proxy access regime proposed by the SEC, the elimination of discretionary broker voting and several other reforms designed to facilitate proxy contests in the election of directors will enhance the ability of would-be acquirers to exert pressure on, and potentially acquire control of, boards of directors.

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

A comprehensive outline of takeover preparedness considerations may be accessed at this link: [Takeover Response Checklist and Dealing with Activist Hedge Funds](#).

## **6. Separation of Chairman and CEO Positions**

Another high-profile governance issue this past year has been the separation of CEO and chairman roles. Shareholder proposals advocating the separation of these positions

have continued to gain traction at annual meetings, with RiskMetrics reporting average shareholder support at 36.3 percent in the 2009 proxy season, an increase of 6.5 percent over 2008. In April 2009, Bank of America separated its CEO and chairman positions after a binding shareholder proposal passed with approximately 50.3 percent support. In addition, following discussions with an activist shareholder, Sara Lee Corporation recently amended its corporate governance guidelines to provide that it will select an independent chairman when its current CEO's tenure has ended, and it has indicated that it intends to amend its bylaws to this effect.

The issue has also attracted the attention of federal legislators, who have incorporated provisions requiring the separation of these roles in the Shareholder Bill of Rights Act and the Shareholder Empowerment Act. These proposals would also require chairs to meet certain independence requirements that could be more stringent than the director independence definition currently used by the NYSE. In addition, the SEC's proposed disclosure reforms would require companies to include information about their leadership structure, including whether and why they have chosen to combine or separate the CEO and chairman positions, and indicate why they believe this is the best structure for the company. Similar disclosures are called for by the Restoring American Financial Stability Act. The SEC would also require companies to disclose whether and why they have a lead independent director, as well as the specific role such director plays in the leadership of the company.

The principal rationale cited in support of separating the CEO and chairman positions is that such separation will enhance the accountability of the CEO to the board and strengthen the board's independence from management. The extent to which this holds true for any given board will, however, vary depending on the specific circumstances and dynamic of the company's leadership structure. For example, a strong, cohesive board may find that it is most effective in performing its monitoring and oversight role by acting as a unified whole, rather than designating an independent chairman to organize this function, and may determine that the advantages of having a CEO chairman with extensive knowledge of the company (as compared to a relatively less informed independent chairman) outweigh potential disadvantages.

In any event, companies that do not have an independent chairman should have a lead director or a presiding director to supplement the chairman's role by, for example: (1) presiding at board meetings at which the chairman is not present, including executive sessions of independent directors, (2) serving as a liaison between the chairman and the independent directors, (3) approving information sent to the board, (4) approving meeting agendas and meeting schedules of the board to assure there is sufficient time for discussion of all agenda items, (5) having the ability to call meetings of the independent directors and (6) if requested by major shareholders, being available for consultation and direct communication with major shareholders where appropriate. The specific contours of a lead director's role should be determined based on the specific needs of the company.

## **7. Director Elections**

One area of corporate governance that has been a focal point of the shareholder empowerment agenda, and has accordingly been subject to some of the most transformational changes in the past year or so, is director elections. For several years, activists have been seeking to enhance their ability to nominate directors and oust directors whom they deem to be in-

adequately responsive to shareholder demands. In many respects, these efforts have been remarkably successful, as evidenced by the widespread adoption of majority voting standards, declassification of board structures, significant withhold-the-vote campaigns and increasing frequency of proxy fights. According to RiskMetrics, the number of proxy fights increased in 2009 to 39 through September (up from 35 for the same period in 2008), with dissidents achieving at least partial victories at 22 of these 39 companies, as well as entering into 36 negotiated settlements prior to a shareholder vote.

Earlier this year, the SEC proposed proxy access rules that would allow a shareholder or group of shareholders who have owned as little as 1 percent of a public company's shares for a one-year period to require the company to include in its proxy statement the shareholder's nominees for up to 25 percent of the board's directors. Higher share ownership requirements of 3 percent and 5 percent would apply for smaller companies. In the event that a company receives director nominations from multiple shareholders or shareholder groups, the SEC has proposed a first-to-file rule that would give priority to the first shareholder to submit a notice of nominations. If adopted, these proxy access rules will give activist and special interest shareholders a very low-cost avenue to seek to influence the company, incentivize shareholders to race to submit nomination notices, encourage election contests on a regular basis, deter qualified people from serving on public company boards and divert management attention and resources from operational and business matters. Although there was speculation that the SEC might rush to act on the proposed rules in time for the 2010 proxy season, the SEC has now indicated it will likely not make a determination until early 2010. A copy of the comment letter our firm submitted to the SEC with respect to the proposed proxy access rules may be accessed at this link: [Comments on the SEC Proxy Access Proposals](#).

In contrast to the SEC's federal "one-size-fits-all" approach to proxy access, Delaware has amended its corporation laws to provide that the board or shareholders of a Delaware company may adopt a bylaw requiring the inclusion of a shareholder's director nominees in the company's proxy solicitation materials. The statute includes a non-exclusive list of conditions that the bylaws may impose on proxy access, including minimum ownership requirements, mandatory disclosures by the nominating shareholder and restrictions on nominations by persons who have acquired a specified percentage of the company's outstanding voting power. In addition, a company's bylaws may require the company to reimburse shareholders for their proxy solicitation expenses, subject to conditions that may be specified in the bylaws. Outside of Delaware, efforts are ongoing to amend the Model Business Corporation Act, which has been adopted in whole or in part in over 30 states, to include a similar proxy access framework. The private-ordering approach of Delaware and the MBCA would enable companies and their shareholders to tailor proxy access rules to the specific circumstances of a company, and would keep the issue of proxy access within the proper realm of state rather than federal law. It remains to be seen, however, whether these state law developments will be preempted by federal mandates.

Another noteworthy development that will significantly impact director elections is the amendment to NYSE Rule 452 to eliminate discretionary voting by brokers in uncontested director elections. Prior to this amendment, uncontested director elections were considered "routine" matters, and thus could be voted by brokers in their discretion if the beneficial shareholders did not timely provide voting instructions. Broker votes comprise a substantial portion of the votes cast (for example, they represented approximately 19.1 percent of the votes cast during the

2009 proxy season), and a relatively low percentage of retail shareholders typically provide voting instructions. As a result, this rule change is expected to significantly increase the voting power wielded by activist institutional shareholders and proxy advisory firms, particularly in the case of companies that have adopted a majority voting standard. Furthermore, because NYSE Rule 452 applies to brokers, the rule change impacts not only NYSE-listed companies, but also companies listed on NASDAQ and other exchanges.

Pending federal legislation would require directors of publicly traded companies to be elected on an annual basis and would mandate a majority voting standard for uncontested director elections, with a resignation policy for directors who do not receive the requisite vote. In addition, in July 2009, the SEC proposed certain modifications to its proxy rules to clarify that persons who conduct withhold-the-vote campaigns and provide shareholders with unmarked duplicate company proxy cards to be used to revoke prior votes will not be disqualified from relying on an exemption from proxy disclosure and filing requirements. In short, while the full scope and impact of recent director election reforms remain to be seen, these reforms are consistent with a new paradigm of governance that features a more central role for shareholders in the governance and management of public companies.

## **8. Communications with Shareholders**

Although companies have been increasingly willing to meet with shareholders to discuss their views on performance, governance, social issues and political matters, a study issued last year reported that there is still “very little evidence suggesting that boards and shareholders are regularly engaging one another in sustained two-way dialogue on governance matters.” However, recent governance reforms such as say-on-pay proposals are prompting a renewed focus on the proper role of direct dialogue between boards and shareholders, as well as the benefits and disadvantages of more open, regular lines of communication. Some activists, for example, have been seeking direct dialogue not only with companies that have had operational or other performance issues, but also more generally with companies in which they invest. In this regard, the Vanguard Group has sent letters to the CEOs of 905 of its largest investments requesting feedback and dialogue on best corporate governance practices.

As shareholders become increasingly empowered by proxy access, withhold-the-vote campaigns, say-on-pay policies and other reforms that give them a greater voice in governance decisions, it will be a practical necessity for directors, in appropriate circumstances and following consultation with management, to accommodate shareholder requests for meetings and other communications. Dialogue may be helpful in increasing the board’s credibility, enhancing the transparency of governance decisions, alleviating the need for shareholder resolutions and proxy fights and otherwise helping the board to avoid contentious relationships with shareholders.

Boards should, however, bear in mind both the advantages and disadvantages of such conversations and evaluate them on a case-by-case basis. Activists are not just seeking “listen only” sessions at which they make known their views; instead, they are incentivized to use the leverage of a potential proxy contest, negative publicity, shareholder resolutions and other pressure tactics to promote the ongoing, routinized brokering of private deals with companies on governance and other matters. Shareholder meetings can also require considerable time and ef-

fort on the part of directors, distract attention away from critical operational and other matters, and undermine the CEO's role as primary spokesperson for the company.

In addition, directors should be mindful of the constraints imposed by Regulation FD, which prohibits the selective disclosure of material non-public information. This year, there has been a renewed focus by the SEC on Regulation FD, including a recent enforcement action and publication of updated SEC guidance on Regulation FD. Due to the lack of a bright line test for determining whether information will be deemed material, and the resulting reluctance of directors to engage in discussions with shareholders, the SEC's new Investor Advisory Committee has been considering whether to recommend that the SEC clarify the application of Regulation FD to discussions of corporate governance matters with shareholders.

In short, shareholder relations have become increasingly complicated as a result of activist trends and each year require greater attention by the board. In determining an appropriate response to requests for meetings, the board should take into account these competing concerns as well as the company's shareholder relations programs, and consider whether it is appropriate for the board or the lead director to have greater interaction with shareholders. In general, management should be the primary caretaker of shareholder relationships, but to the extent that the board determines that directors should meet with shareholders, it should take care to coordinate with management and all of the directors to speak with a unified voice and avoid confusion or contradiction in the company's public posture.

## **9. Shareholder Proposals**

In the past year or so, efforts to promote corporate governance reform by means of shareholder proposals have been largely overshadowed by the more sweeping federal, state and foreign legislative and regulatory initiatives. Governance issues are currently being debated not only in the context of specific companies at their annual shareholder meetings, but much more broadly in Congress, the White House, the SEC, the national media and various other national and global forums. Shareholder activists have been afforded new avenues of influence, and government regulators have taken on a new role in shaping corporate governance structures and policies—including by exercising rights in their new role as shareholders of public companies.

Notwithstanding this shift, shareholder proposals continued to gain traction in 2009 and had a real impact on many companies. According to RiskMetrics data, 37 percent of the governance proposals to go to a vote in the 2009 proxy season received majority support, up from 30.2 percent in 2008. Proposals relating to shareholder rights to call special meetings, majority voting in director elections and board declassification received the most majority votes in 2009. In addition, say-on-pay resolutions received an average of 46 percent shareholder support, and proposals seeking independent board chairs averaged 36.3 percent support. RiskMetrics has also reported that 91 directors at 49 U.S. companies failed to receive majority shareholder support in 2009, including several situations where votes were withheld from directors due to their companies' failure to implement majority-approved shareholder resolutions.

In the 2010 proxy season, activists will continue to push their agendas through shareholder proposals as part of their effort to maintain the regulatory momentum and demon-

strate continued investor support and focus on corporate governance matters. Directors should consider whether shareholder proposals can be accommodated without significant difficulty or harm to the company, bearing in mind that their receptiveness to shareholder demands is being carefully monitored by activists and proxy advisors and, in this environment, could generate significant publicity. In some circumstances it may be advisable to adopt a “wait and see” approach, while other situations may warrant a more proactive approach. For example, several companies have voluntarily adopted say-on-pay voting policies and have used the opportunity afforded by early action to tailor such policies, as in the case of Microsoft’s triennial say-on-pay policy.

## **10. Competition in the Global Market**

As noted above, in the last several months, regulators and lawmakers have proposed a dizzying array of reforms that, if implemented, threaten to exacerbate short-termism, undercut directorial discretion, further empower institutional investors and shareholder activists, and impose unnecessary and potentially costly burdens on public companies. These proposals proceed in part from a misguided impulse on the part of regulators and lawmakers to be seen as “doing something” about the current recessionary environment—though hardly any of the proposed reforms have any real connection to the origins of the credit crisis that precipitated the economic downturn—and in part from an opportunistic desire to use the financial crisis as an excuse to enact an activist “wish list” of reforms.

Unfortunately, these proposals come at a time when it is vital for American companies to have stability and to be encouraged to adopt long-term growth strategies to create future value by investing in research and development, marketing and plant and equipment. Increasing the power of shareholders to pressure companies and their boards to maximize short-term profits and stock prices will interfere with the objective of long-term value creation (and concomitant increase in employment). American companies will not be able to compete in the global marketplace with companies that have the advantages of state corporatism, like those in China, if they are forced by activist shareholders to pursue short-term goals. The misguided populist attempt to blame American management and boards for the economic crisis runs the real risk of eventually reducing American business and the American economy to secondary status in the world.

## **III. THE ROLE AND DUTIES OF THE BOARD**

In the wake of the economic crisis, directors have been reassessing the proper role and functioning of their boards and searching for ways to improve board effectiveness. In this regard, there are no off-the-shelf checklists that will guarantee optimal board functioning. The most effective boards tend to be those that take the time to go beyond the generally prescribed “best practices” and craft bespoke procedures and structures that are carefully calibrated to the needs of the company. In many respects, the process is about finding the right balance in the absence of bright lines—including a balance between the board’s monitoring and advisory functions, and a balance between a “hands on” approach to oversight and more direct engagement in the management of the company.

While the board has always had a dual role as a resource for and advisor of management, on the one hand, and as the monitoring representative of the shareholders on the other, regulators and activist shareholders have been tipping this balance in favor of the board's monitoring role. The role has also gained increasing prominence as a result of the current emphasis on effective risk management. A combination of the monitoring and advisory roles is, however, necessary for a board to be truly effective, and each board must find the right balance.

Another key component of a board's effectiveness is its ability to effectively oversee management—by cultivating dialogue and transparency, asking the right questions, challenging assumptions, and monitoring the flow of information to the board in order to ensure a thorough understanding of the company—while at the same time maintaining its fundamental role of oversight rather than direct management of the company. The challenge is to advise and guide management without preempting their responsibility for running the business.

This Part III outlines key board roles and responsibilities, which are in addition to the board's duties with respect to CEO succession planning, communications with shareholders, director recruitment, risk management and other functions discussed in other parts of this memorandum.

## **1. Tone at the Top**

One of the most important factors in ensuring that a board functions effectively and is able to meet all of its responsibilities is having the right “tone at the top” of the corporation. The tone at the top shapes corporate culture and permeates the corporation's relationships with investors, employees, customers, suppliers, regulators, local communities and other constituents. The board should work with the CEO and senior management to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, and full compliance with legal requirements, and to ensure that the company's strategic goals are ethically sound.

In setting the tone at the top, transparency and communication is key: the board's vision for the corporation, including its commitment to ethics and zero tolerance for compliance failures, should be set out in the annual report and communicated effectively throughout the organization. The company's code of conduct and ethics should be incorporated into the company's strategy and operations, with appropriate supplementary training programs for employees and regular compliance assessments.

## **2. Monitoring Performance and Compliance**

As discussed above, a board of directors needs to be able to perform the role both of a business and strategic advisor to management and as a monitor of management performance and compliance. To enable the board to effectively perform its monitoring functions, the board and management should together determine the information the board should receive and periodically reassess its information needs. The key is to provide useful and timely information without overloading the board with, for example, all information that the CEO and senior management receive. As a starting point, the board should receive financial information that readily enables it to understand results of operations, variations from budget, trends in the business and

the corporation's performance relative to peers. In addition, the board should receive copies of significant security analysts' reports, press articles and other media reports on the corporation. By tracking these reports and articles, the board will avoid not only unpleasant surprises but also the possibility of being accused of ignoring problems that were known to others and that could have been known by the directors. The board should also promote lines of communication that will foster open and frank discussions with senior management, and management should be comfortable in informing the board or relevant committees of issues and developments.

### **3. Corporate Strategy and Major Plans**

In the board's role as business and strategic advisor, understanding and approval of the corporation's long-term strategy and major plans of action is a core board function. Strategy, business plans and the annual budget should be formulated initially by management and then developed fully in an interactive dialogue with the board, with periodic review, reassessments and revision as appropriate. As part of the strategic review, the board should also consider the company's vulnerabilities and other contingencies and determine an appropriate risk appetite for the company. The board should oversee major capital expenditures, acquisitions and divestitures, and other major initiatives undertaken as part of the company's overall strategic plan.

As noted above, pressures to focus unduly on short-term stock price performance present real challenges in crafting and maintaining long-term growth strategies. The board's ability to craft a strategic vision and manage these pressures can be essential to the overall best interests of the company. The board's duties to shareholders do not require the board to ignore the interests of the company's other constituencies—including employees, creditors, customers and local communities. Managing these constituencies in order to position the company for long-term health, growth and value is in the interest of the company, its shareholders and all of its constituencies.

### **4. Crisis Management**

In recent years, the crisis management skills of many boards have been put to the test, including as a result of unexpected departures of CEOs and other senior executives, rapid deterioration of business conditions, impending liquidity shortfalls, public uproar over executive compensation packages and many other challenges. Boards should be carefully attuned to the risk profiles and vulnerabilities of their companies, with a view toward anticipating potential crises. Once a crisis starts to unfold, boards need to be proactive in taking the reins. The first decision a board must make during a crisis is whether the CEO should lead the corporation through the crisis. If the CEO is part of the problem or is otherwise compromised or conflicted, someone else—often one of the other directors—should take a leadership role. If the CEO is not compromised or conflicted, the CEO should lead the corporation's response to the crisis.

In some cases, boards appear either to have overreacted, or to have placed matters in the hands of lawyers, accountants and other outside experts, and thereby lost control of the situation to those outsiders. In particular, the proliferation of independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisors, can be time-consuming and distracting, can sour relationships between independent directors and management, and in extreme cases can result in the lawyers for

the special committee hijacking the company and monopolizing the attention of directors and senior management.

Each crisis is different and it is difficult to give general advice that will be relevant to any particular crisis without knowing the facts involved. That said, in most instances when a crisis arises, the directors are best advised to manage through it as a collegial body working in unison. While there may be an impulse to resign from the board upon the discovery of a crisis, directors are best served in most instances if they stay on the board until the crisis has been fully vetted and brought under control. Trusted and experienced advisors can be helpful in assisting the board to gather information and evaluate options, but directors should maintain control and not cede the job of crisis management to outside advisors.

#### **IV. THE COMPOSITION AND STRUCTURE OF THE BOARD**

##### **1. Independence**

One of the key themes of the shareholder rights agenda over the past several years has been advocacy of boards composed almost exclusively of independent directors as well as increasingly narrow standards of independence for directors. Many of the shareholder advisory services, institutional investors and academic gadflies are continuing to urge (in some cases, demand) that all or almost all directors be independent and that independence be measured based on a litany of factors designed to ferret out any current or former relationships between the director and the company, between the director and other directors and between the director and organizations that have relationships with the company.

The emphasis on director independence should not cause the board to lose sight of the importance of a well-functioning board and an effective partnership between the board and senior management. What companies need are directors who possess sufficient character and integrity to allow them to make judgments that are unbiased by personal considerations. The concept of directors as remote strangers and the board as primarily an agency for the discipline of management, rather than as an advisor to management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance.

Furthermore, one of the lessons to emerge from the financial crisis has been a realization that companies today must manage increasingly complex businesses and market conditions. An obvious illustration is provided by the highly sophisticated securitized credit instruments that formed the basis of a significant portion of many financial firms' businesses and an integral part of their risk profiles, but business complexity has increased in a number of other industries as well. The reality is that directors who meet today's stringent standards of independence may be relatively inexperienced in the company's business and lack real expertise and understanding of relevant industries and markets. The Lorsch study, for example, concluded that "[a]s a practical matter it is difficult, if not impossible, to find directors who possess deep knowledge of a company's process, products and industries but who can also be considered independent." In short, the irony is that in seeking to ensure independent directors who will hold management more accountable, the result has been to promote directors who are more wholly dependent on management to inform their views of the company and its businesses.

While purity of independence should thus not take precedence over other factors, directors should be careful in the current environment to make full and complete disclosure of any relationships or transactions that could be deemed to affect independence. SEC rules require companies to identify their independent directors (based on applicable NYSE or NASDAQ standards) and to disclose any transactions or relationships that were considered in determining that those directors were independent. Many relationships that may have been considered commonplace in the past (such as a director's involvement with a nonprofit organization that is supported by the company) may, in today's skeptical environment, cast doubt on the level of that director's independence when viewed in hindsight after a crisis has arisen. This is not to say that all such relationships should be prohibited, but rather that all should be considered in assessing a director's independence. A practical way to deal with situations where such relationships might raise an issue as to the independence of the directors acting on a particular matter is to consider delegating that matter to a committee of directors, each of whom is free of such relationships.

## **2. Director Recruitment**

The recruitment and nomination of director candidates has become a key challenge for many boards, as it has become increasingly difficult for companies to recruit directors with the level of relevant experience and qualifications they may seek. The Sarbanes-Oxley Act resulted in a pronounced increase in the workload and risks associated with directorships, and dilemmas precipitated by the economic crisis, as well as the concomitant wave of corporate governance reforms, have further increased the time commitment and risks of board service. In some cases, directors have been tasked with numerous special board meetings in order to deal with crises. Furthermore, proxy access and other reforms designed to increase the frequency of contested elections and withhold-the-vote campaigns may increase the reluctance of qualified individuals to serve on public company boards. As noted above, director recruiting is also complicated by the ever-narrowing definition of director independence as well as the threat of shareholder litigation and other public attacks on directors.

The foremost criterion for director candidates is competence: boards should consist of well-qualified men and women with appropriate business and industry experience. Boards should be willing to explain that it was more important to have directors with relevant experience than to meet the continuously elevating independence criteria demanded by governance activists. Banking institutions in particular have been under considerable pressure to increase the level of expertise on their boards; for example, in May, a joint statement issued by the Department of Treasury, Federal Reserve, FDIC and Comptroller instructed banks to review their existing board membership "to assure that the leadership of the firm has sufficient expertise and ability" to manage risks and maintain sufficient balance sheet capacity. The SEC has also proposed proxy reforms that would require companies to disclose the particular experience, qualifications, attributes or skills that qualify each director and nominee to serve on the company's board. If the CEO is the sole management representative, consideration may be given to adding a second or third management representative, such as the COO, CFO or chief risk officer, to provide an additional source of direct input and information on the company's business, operations and risk profile in the boardroom.

The second most important yet often underemphasized consideration is collegiality. A balkanized board is a dysfunctional board; a board works best when it works as a unified

whole, without camps or factions and without internal divisions. Strong, independent directors are essential to proper board functioning, but so too are elusive qualities such as collegiality, sense of common purpose, energy, industry knowledge, business sense and trust. Diversity of views and backgrounds can also enhance boardroom discussions.

The nominating committee should seek to ensure that the board consists of individuals who understand and are willing to shoulder the substantial time commitment necessary for the board to effectively fulfill its responsibilities. To this end, companies should consider including in their corporate governance guidelines policies limiting the number of boards on which a director may sit. While active CEOs are often uniquely qualified to provide business and strategic advice, the significant demands on their time may make it difficult for them to serve on multiple outside boards. Companies should also consider whether it would be advisable to impose term or age limits on directors.

## **V. BOARD COMMITTEES**

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

The requirement that a committee be composed of only independent directors does not mean that the CEO and other executives should be excluded from all discussions or work of the committee. Indeed, it would be virtually impossible for committees to function effectively without the participation of the CEO. Compensation matters, including the CEO’s compensation, as well as governance and director nomination matters, should be discussed with the CEO. While the committee is tasked with making the recommendation to the board, there is no restriction on full discussion with the CEO or on the CEO informing the board of any disagreement the CEO has with the committee.

The committees should have the authority to retain consultants and advisors. However, committees should be careful to exercise their own independent judgment and not to over-rely on consultants. A corporation’s own general counsel or CFO can often provide more pertinent advice and insight than that available from outside sources.

In addition to the core committees, boards may wish to establish additional standing committees to meet ongoing governance needs appropriate to the company’s particular business or industry, such as a risk management committee (if this function is not being performed by the audit committee), a compliance committee or a committee on social responsibility. Boards may also use special committees from time to time to deal with conflict transactions (such as a management buyout) or other major corporate events (such as shareholder litigation or a hostile takeover bid) or to address particular investigations or projects. While the use of special committees is appropriate and useful in many circumstances, such committees are also often used in situations where it might be best to keep the matter before either the full board or all of

the non-executive members of the full board. Special committees can sometimes become divisive in sensitive situations, and there is a risk that the special committee and its outside advisors may take a matter in a direction that would be different than that desired by the full board.

The work of the board will be facilitated by establishing the appropriate relationship between the board as a whole and each of its committees. The board should take care to oversee the coordination and staffing of its committees to ensure that the work of the committees is neither duplicated nor ignored by the board as a whole. In a regulatory environment where audit, compensation, and nominating and governance committees must be composed solely of independent directors, and where those committees are tasked with ever increasing responsibilities, it is particularly important that boards avoid balkanization and keep the full board, as well as management, apprised of significant actions.

### **1. Board and Committee Agendas**

The board and its committees should be proactive in working with senior management and the general counsel in setting their agendas for the year as well as for each board or committee meeting. While it is management, not the board, that must initiate the strategic and business agenda for the company, directors should take a leadership role in defining the bounds of their oversight and responsibilities. The meeting agendas and the overall annual agenda should reflect an appropriate division of labor and should be distributed to the board or committee members in advance. Board and committee meetings should be regularly scheduled and should provide sufficient time for directors to discuss the matters on the agenda.

### **2. Audit Committee**

In large measure, the audit committee has become the principal means by which the board monitors financial and disclosure compliance. Accordingly, boards should carefully select audit committee members and, to the greatest extent possible, be attuned to the quality of the audit committee's performance. In view of the audit committee's centrality to the board's duties of financial review, it is important for the board as a whole to receive periodic reports from the audit committee and to be comfortable that the audit committee, the auditors and management are satisfied that the financial position and results of operations of the corporation are fairly presented. The audit committee should also satisfy itself, by getting regular reports from management and the internal auditor, that the company's existing internal control systems provide for the maintenance of financial records in a way that permits preparation of financial statements in accordance with GAAP and gives "reasonable assurance" of accuracy in financial reports, and that management designs and supervises processes that adequately identify, address and control compliance risks.

A more comprehensive overview of the responsibilities and procedures of audit committees is set forth in our Audit Committee Guide, which may be accessed at this link: [Audit Committee Guide](#).

### **3. Risk Management Committee**

The NYSE rules provide that an audit committee must "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken," and

accordingly in many companies the audit committee takes the lead in overseeing the risk management function. However, the NYSE rules permit a company to create a separate committee or subcommittee to be charged with the primary risk oversight function, as long as the risk oversight processes conducted by that separate committee or subcommittee are reviewed in a general manner by the audit committee, and the audit committee continues to discuss policies with respect to risk assessment and management.

In some companies, the scope and complexity of risk management may make it desirable to create a dedicated risk management committee or a subcommittee of the audit committee in order to permit greater focus at the board level on risk management. Given the myriad obligations specifically mandated or delegated to it by law and regulations, the audit committee may not have sufficient time to devote to optimal risk oversight, and its focus on compliance with auditing and accounting standards is not necessarily the right focus for identifying and assessing the broad array of risks that the company may face. Indeed, it is quite possible for strict compliance with accounting rules to mask risk, as occurred with the creation of structured investment vehicles and other off-balance sheet entities. Additional factors to consider in evaluating the merits of a separate risk committee are discussed in the memorandum, “Risk Management and the Board of Directors,” which is referenced and linked above.

Notably, the proposed Shareholder Bill of Rights Act would require all public companies to establish a risk committee, composed entirely of independent directors, to be responsible for the establishment and evaluation of risk management practices. In addition, the discussion draft of the Restoring American Financial Stability Act would require certain financial institutions to establish a risk committee to supervise enterprise-wide risk management practices. The risk committee would be required to include at least one risk management expert with experience in identifying, assessing and managing risk exposures.

If the company keeps the risk oversight function in the audit committee and does not establish a separate risk committee or subcommittee, the audit committee should schedule time for periodic review of risk management outside the context of its role in reviewing financial statements and accounting compliance. While this may further burden the audit committee, it is important to allocate sufficient time and focus to the risk oversight role specifically.

#### **4. Nominating and Governance Committee**

The responsibilities of the nominating and governance committee have become particularly important due to escalating challenges in recruiting qualified director candidates as well as the proliferation of corporate governance reforms. For example, proposed changes relating to proxy access, the elimination of discretionary broker voting, majority voting standards and declassification of boards are designed to significantly increase the ability of activist shareholders to conduct effective withhold-the-vote campaigns and the frequency of contested director elections. The nominating and governance committee should promote a formal and transparent director nomination and election process, with appropriate consideration of candidates proposed by shareholders and other constituents. In addition, to the extent that direct communications between directors and shareholders become a practical necessity in some circumstances, the nominating and governance committees of many companies will play a key role in overseeing such communications.

In short, the corporate governance landscape is in the process of undergoing substantial reassessment and change, and many of these changes will impact the responsibilities of the nominating and governance committee and the issues that it is tasked with managing. The committee should monitor the company's governance practices and critically evaluate potential changes to align these practices with current requirements and best practices. A number of key issues to consider are discussed in Part II above under "Separation of Chairman and CEO Positions," "Director Elections," "Communications with Shareholders" and "Shareholder Proposals" and in Part IV above under "Independence" and "Director Recruitment."

## **5. Compensation Committee**

The intense public scrutiny and flurry of proposed reforms surrounding executive pay practices has put the compensation committees of many companies squarely in the public spotlight. Compensation committees should carefully review pay policies in light of pay-for-performance principles and the interaction between pay packages and risk-taking incentives, while remaining focused on the need for compensation structures that will permit the company to recruit and retain first-rate executives. See the section titled "Executive Compensation" in Part II above and the section titled "Director Compensation" in Part VI below for a discussion of some of the relevant issues.

Compensation committee members should also note recent reform proposals that would require them to meet heightened independence standards similar to those applicable to audit committee members. The Corporate and Financial Institution Compensation Fairness Act would provide that compensation committee members may not, other than in their capacity as a member of the board or board committees, accept any consulting, advisory or other compensatory fee from the company, and the Investor Protection Act would also provide that compensation committee members may not be affiliated with the company. The discussion draft of the Restoring American Financial Stability Act would require the SEC, in determining the applicable independence standard, to consider a member's source of compensation and whether the member is affiliated with the company.

In addition, several proposed reforms raise issues relating to the retention of compensation consultants and other external advisors. The Shareholder Empowerment Act would require that any compensation consultants retained in conjunction with negotiating employment contracts or compensation agreements with the company's executives must be independent of the company, its executives and its directors and must report solely to the board or the board committee responsible for executive compensation. Companies would not be allowed to agree to indemnify or limit the liability of compensation consultants. The Investor Protection Act, the Corporate and Financial Institution Compensation Fairness Act and the Restoring American Financial Stability Act would require compensation committees to have their own authority to retain and oversee compensation consultants and outside legal counsel who meet independence requirements to be established by the SEC. Companies would be required to disclose in their proxy statements whether they retained and obtained the advice of compensation consultants meeting these independence standards, and if independent consultants have not been retained, the Investor Protection Act would require an explanation of the compensation committee's determination not to retain such consultants. In addition, the SEC has proposed proxy disclosure re-

forms that would impose detailed disclosure requirements regarding compensation consultants who advise on executive or director compensation and provide other services to the company.

A more comprehensive overview of the responsibilities and procedures of compensation committees is set forth in our Compensation Committee Guide, which may be accessed at this link: [Compensation Committee Guide](#).

## **VI. BOARD PROCEDURES**

### **1. Executive Sessions**

The NYSE requires listed companies to hold regular executive sessions of non-management directors and, if those sessions include directors who do not qualify as independent under the NYSE standards, the NYSE recommends that companies also schedule an executive session of independent directors at least once a year. Earlier this year, the NYSE proposed amendments to clarify that these requirements may be satisfied by holding regular meetings of only independent directors.

Each board should determine the frequency and agenda for these meetings, although in practice, the trend has been toward scheduling regular executive sessions at every board meeting. Executive sessions provide the opportunity for meaningful review of management performance and succession planning, and can serve as a safety valve to deal with problems. They should not be used as a forum for revisiting matters already considered by the full board, and should not usurp functions that are properly the province of the full board. Boards should be careful that the use of executive sessions does not have a corrosive effect on board collegiality and relations with the CEO.

### **2. Director Education**

The economic crisis has highlighted the complexity of many financial, risk management and other issues facing companies today, and there has accordingly been a renewed focus on director education. Nearly one-third of directors surveyed for the National Association of Corporate Directors' 2009 public company governance survey reported that their boards were not effective in this area. In addition to ongoing information flows and dialogue with management, boards should consider the desirability of an annual two- to three-day board retreat with the senior executives and, where appropriate, outside advisors, at which there is a full review of the corporation's financial statements and disclosure policies, risk profile, strategy and long-range plans, budget, objectives and mission, succession planning and current developments in corporate governance. To the extent that directors lack the knowledge required for them to have a strong grasp of important issues, companies should consider the usefulness of tutorials for directors, as a supplement to board and committee meetings and in order to keep directors abreast of current industry and company-specific developments and specialized issues. Training and tutorials should be tailored to the issues most relevant and important to the company and its business. Site visits may also be valuable for directors where physical inspection is important for more fully understanding the business and operations of a company.

Corporations should also provide comprehensive orientation for new directors. The annual retreat could satisfy a major portion of such an orientation. The content of orienta-

tion and training programs should be reviewed to make sure that such programs enable new directors to gain an understanding of the company's business quickly, and an overview of the company's risk profile should be incorporated into that training. If necessary, additional time and content should be devoted to educating new directors so that they have a full picture of the company.

### **3. Charters, Codes, Guidelines and Checklists**

The SEC and the NYSE have imposed various requirements on corporations relating to the adoption and/or disclosure of a code of ethics, corporate governance guidelines, policies and procedures for reviewing related party transactions and charters for audit, compensation and nominating committees. There is no end to the number of recommended checklists designed to assist corporations in complying with these requirements. All of these are to some extent useful in assisting the board and committees in performing their functions and in monitoring compliance, but care should be taken to ensure that procedures and policies are tailored to the specific needs of the company and are limited to what is truly necessary and feasible to accomplish in actual practice. If a charter or checklist requires review or other action and the board or committee has not taken that action, the failure may be considered evidence of a lack of due care.

Charters and checklists should be carefully reviewed each year to prune unnecessary items and to add items that will in fact help directors in discharging their duties. One update that may be warranted in light of recent developments is an expansion of corporate compliance policies to cover not only bribery of foreign government officials, but also bribery of foreign private individuals. Earlier this year, the Department of Justice prosecuted a case of foreign commercial bribery pursuant to the Travel Act which, in contrast to the DOJ's aggressive enforcement of the Foreign Corrupt Practices Act, has seldom been used by the DOJ in the overseas context. The case may signal a new willingness by the DOJ to use the Travel Act to begin a similar campaign against foreign commercial bribery. In addition, there have been increased enforcement efforts by foreign prosecutors and regulators—as evidenced by Siemens AG's guilty plea last year following joint U.S.-German enforcement efforts, as well as the conviction of Mabe & Johnson Ltd. in the U.K. earlier this year. Companies need to consider more than just the U.S. anti-bribery and anti-corruption regulations and should update their global compliance programs to address international rules.

### **4. Confidentiality and Communications by Directors**

Confidentiality is essential for an effective board process and for the protection of the corporation and its stockholders. A board should function as a collegial body, and directors should respect the confidentiality of all discussions that take place in the boardroom. Moreover, directors generally owe a broad legal duty of confidentiality to the corporation with respect to information they learn about the corporation in the course of their duties.

Maintaining confidentiality is also essential for the protection of individual directors, since directors can be responsible for any misleading statements that are attributable to them. Even when a director believes the subject matter of his or her statements is within the public domain, it is good practice for individual directors to avoid commenting on matters concerning the corporation. A director who receives an inquiry with respect to the corporation may

or may not have all of the relevant information, and his or her response could involve the corporation, as well as the director, in a disclosure violation.

Directors should respect the role of the CEO as the chief spokesperson for the corporation, and they should generally not engage in discussions with outsiders concerning corporate business unless specifically requested to do so by the CEO or the board. As noted in Part II above in the section titled “Communications with Shareholders,” activists have been focused on opening more direct lines of communication between shareholders and directors, and boards may determine that such dialogue is advantageous in some circumstances. It is generally advantageous for one member of the board to be designated as the board’s spokesperson. Where a board has a non-executive chairman or a lead director, under certain circumstances it may also be appropriate for the chairman or lead director to speak on behalf of the corporation, particularly within the ambit of those directors’ special roles. In the ordinary course, all such matters should be handled in close consultation with the CEO so as to avoid confusion in the corporation’s public statements and posture.

## **5. Minutes**

Careful and appropriate minutes should be kept of all board and committee meetings. Courts and regulators often raise questions about the amount and scope of attention that was spent on a matter when the minutes did not adequately support the recollection of the directors as to what transpired. The minutes should reflect the discussions and the time spent on significant issues, both in the meeting and prior to the meeting, and should indicate all those who were present at the meeting and the matters for which they were present or recused. Depending on the matters considered at executive sessions, it may be appropriate to have summary minutes or in some cases very extensive or even verbatim minutes of such sessions. Taking appropriate minutes is an art, and the secretary of the company and the general counsel should work with the directors (and outside counsel where appropriate) to ensure that the written record properly reflects the discussion and decisions taken by the board.

## **6. Board, Committee and CEO Evaluations**

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

## **7. Reliance on Advisors**

In discharging their obligations, directors are entitled to rely on management and the advice of the corporation's outside advisors. The board should make sure that the corporation's legal counsel, both internal and external, and auditors, both internal and external, have direct access to the board or relevant board committee, if needed. However, the board should also guard against overuse of outside advisors. The parade of lawyers, accountants, consultants and auditors through board and committee meetings can have a demeaning effect. While it is salutary for boards to be well advised and outside experts may be necessary to deal with a crisis, over-reliance on experts tends to reduce boardroom collegiality, distract from the board's role as strategic advisor, and call into question who is in control—the directors or their army of advisors.

## **8. Director Compensation**

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

The compensation committee or the nominating and governance committee should determine or recommend to the board the form and amount of director compensation with appropriate benchmarking against peer companies. It is legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time, including special committees formed to review major transactions or litigation. The SEC's proxy disclosure rules call for tabular and narrative disclosure of all director compensation, including cash fees, equity awards, and deferred and other compensation.

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

## **9. Whistle-Blower Policies**

Boards, and in particular audit committees, are required to establish procedures to enable employees to submit concerns, confidentially and anonymously, that they might have regarding the company's accounting, internal controls or auditing matters. In addition, companies

are subject to potential civil and, in some cases, criminal liability if they can be shown to have taken retaliatory action against a whistle-blower who is an employee. A reasonable procedure should be established to filter whistle-blower complaints and identify those that merit investigation. The SEC has urged companies to appoint a permanent ombudsman or business practices officer to receive and investigate complaints. Boards should ensure the establishment of an anonymous whistle-blower hotline and a well-documented policy for evaluating whistle-blower complaints, but they should also be judicious in deciding which complaints truly warrant further action.

#### **10. Major Transactions**

Board consideration of major transactions, such as acquisitions, mergers, spin-offs, investments and financings, needs to be carefully structured so that the board receives the information necessary in order to make an informed and reasoned decision. If the corporation has the internal expertise to analyze the requisite data and present it in a manner that enables the board to consider the alternatives and assess the risks and rewards, the board is fully justified in relying on the management presentation without the advice of outside experts. However, while outside experts are not always necessary, it may be highly desirable for the board to retain experienced outside advisors to assist with major transactions, particularly where there are complicated financial, legal or other issues or where it is useful for the board to obtain objective outside guidance.

There is generally no need for the board to create a special committee to deal with a major transaction, even a hostile takeover, and experience shows that a major transaction not involving a specific conflict of interest is usually best addressed by the full board. Management should build a strong foundation to support a major transaction, including an appropriate due diligence investigation. Unless for documented good reasons it is not practical, the board should have ample time to consider a major transaction including, in cases of complicated transactions and agreements, by means of a two-step process with the actual approval coming only after an initial presentation and the board having had time for reflection.

#### **11. Related Party Transactions**

Boards are generally not comfortable with related party transactions and today most companies avoid them. However, there is nothing inherently improper about transactions between a corporation and its major shareholders, officers or directors. Such transactions can be in the best interest of a corporation and its shareholders, offering efficiencies and other benefits that might not otherwise be available. It is entirely appropriate for an informed board, on a proper record, to approve such arrangements through its disinterested directors. As a matter of compliance and best practices, however, and particularly in the current environment, the board should give careful attention to all related party transactions. The board should monitor potential conflicts of interest of management, directors, shareholders, external advisors and other service providers, including with respect to related party transactions. In addition, full disclosure of all material related-party transactions and full compliance with proxy, periodic reporting and financial footnote disclosure requirements is essential.

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

## **VII. ZONE OF INSOLVENCY**

While some companies have fared better than others in the economic recession, no company has been fully immune from the financial downturn, and even some that were previously admired for their solid financials and conservative balance sheets have seen their financial prospects and stock prices drop precipitously. In this environment, boards should bear in mind that there are unique risks and considerations that arise when a company is approaching the "zone of insolvency"—the ill-defined gray area where a company is on the brink of becoming insolvent. Among other things, there is a heightened risk of litigation, as board decisions may be scrutinized by shareholders, creditors and others in circumstances where losses for some stakeholders may be unavoidable. Directors may in certain circumstances face heightened risks of liability, such as potential personal liability for dividends that render the company insolvent. Directors should also note that legal documents protected by the attorney-client privilege may later become available to adverse parties if the company enters bankruptcy proceedings.

Furthermore, once a company is actually insolvent, creditors become the residual beneficiaries of any increase in value of the company and are also the principal constituency injured by fiduciary duty breaches that diminish this value. As a result, Delaware courts have established that creditors of an insolvent corporation have standing to bring derivative claims for fiduciary duty breaches. Unfortunately, the line between solvency and insolvency can be murky, and the solvency of a corporation can rapidly deteriorate. Both shareholders and creditors may have different views as to whether and when the solvency line has been crossed, and both may seek to litigate these views and challenge board decisions with the benefit of hindsight. When a company is reaching the point of insolvency, directors must be mindful of the interests of creditors in addition to the interests of the company and shareholders, and exercise caution in addressing potential conflicts of interest among these constituencies.

In short, directors of financially distressed companies face unique risks and complicated decisions, and such companies should seek the advice of outside financial and legal advisors with respect to, among other things, determinations of solvency, fiduciary obligations, and the legal and financial implications of turnaround strategies and capital-raising transactions. A more comprehensive outline of basic bankruptcy concepts and legal considerations to bear in mind when a company is approaching the zone of insolvency may be accessed at this link: [Managing Stress and More: A Corporate Lawyer's Guide to Business Decisions in the Current Environment](#).

## VIII. DIRECTOR LIABILITY

### 1. Personal Liability of Directors

Notwithstanding the wave of subprime-related and other litigation that has been generated by the economic crisis, the Delaware courts have confirmed that they will continue to protect informed business judgments made in good faith by corporate boards. In the Citigroup derivative action decided in the early part of 2009, the Delaware Court of Chancery reaffirmed and clarified several key features of Delaware law, established by the Caremark decision and its progeny, with respect to oversight responsibilities. The plaintiffs in the Citigroup case alleged that the defendants, who were current and former directors of Citigroup, had breached their fiduciary duties by not properly monitoring and managing the business risks that Citigroup faced from subprime mortgages and securities, and by ignoring alleged “red flags” that consisted primarily of press reports and events indicating worsening conditions in the subprime and credit markets. Declaring that “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 court dismissed these claims. In doing so, the court reaffirmed the “extremely high burden” plaintiffs face in bringing a claim for personal director liability for a failure to monitor business risk and that a “sustained or systemic failure” to exercise oversight is needed to establish the lack of good faith that is a necessary condition to liability. The decision also drew an important distinction between oversight liability with respect to business risks and oversight liability with respect to illegal conduct, emphasizing that Delaware courts will not permit “attempts to hold director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly.” Bad business decisions are not evidence of bad faith.

The Citigroup court observed that its decision to block further litigation against the Citigroup directors could be thought to be at variance with the result in another recent Delaware case involving shareholder claims arising out of conduct by American International Group, Inc. (AIG). In the AIG case, the Delaware Court of Chancery allowed claims based on alleged fraud and illegalities at AIG to survive a motion to dismiss, relying in part on a theory that the defendants (some of whom were AIG directors) had “consciously failed to monitor or oversee the company’s internal controls.” However, the individual defendants in the AIG case were executives and inside directors who were allegedly “directly knowledgeable of and involved in much of the wrongdoing,” rather than independent, non-executive directors. Moreover, the Citigroup court relied on the distinction between business decisions and matters of corporate fraud and violations of law.

Although the Citigroup decision has affirmed that the business judgment rule is alive and well in Delaware, directors should recognize the possibility that what constitutes a sustained or systemic failure to exercise oversight may be evaluated in the future with heightened focus and with the benefit of hindsight. It is also important to note that courts have taken the view that a breach of duty for failure to exercise oversight would be a breach of the duty of loyalty, which is not subject to exculpation or indemnification by the company. Accordingly, a board is best advised to act well above the minimal standards established by Citigroup and Caremark.

Another notable case decided in 2009 was the Delaware Supreme Court's decision in Lyondell Chemical Co., in which the court rejected an attempt to impose personal liability on directors for their actions in responding to acquisition proposals and reaffirmed the board's wide discretion in managing a sale process. The court reasoned that "[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties," and directors would only breach their duty of loyalty "if they knowingly and completely failed to undertake their responsibilities." The Lyondell decision confirms that disinterested, independent directors will be protected by an exculpation provision in the company's charter, and will not face the threat of personal monetary liability unless truly egregious circumstances are shown in which the directors consciously disregarded their duties by failing to attempt to obtain the best available sale price.

Apart from state law fiduciary duty considerations, directors should bear in mind federal securities laws, which pose a separate threat of personal liability. The WorldCom and Enron settlements, in which directors agreed to personal payments, were federal securities law cases. Directors are liable for material misstatements in or omissions from registration statements that the company has used to sell securities unless the directors show that they exercised due diligence. To meet their due diligence obligation, directors should review and have a general understanding of the registration statements and other disclosure documents that the corporation files with the SEC. In doing so the directors can rely on the accountants with respect to the audited financial statements and on other experts, provided that the directors have no reason to believe that the expert is not qualified or is conflicted or that the disclosure is actually false or misleading. Directors are also well advised to have the corporation's legal counsel present the company's SEC disclosure documents for the directors' review and to receive the advice of counsel that the process they have followed fulfills their due diligence obligation. While directors are not expected to focus on all comments made by the staff of the SEC, it is appropriate for them to have an understanding of significant changes made in response to SEC comments and any unresolved comments, to the extent material to the company.

## **2. Indemnification, Exculpation and D&O Coverage**

Given the heightened risk of litigation stemming from recent market conditions, boards should ensure they have state-of-the-art indemnification and D&O insurance arrangements. All directors should be indemnified by the company to the fullest extent permitted by law, and the company should purchase a reasonable amount of D&O insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed regularly to ensure they provide the fullest coverage available.

In August 2009, Delaware law was amended to provide that advancement and indemnification rights under a charter or bylaw provision cannot be impaired by an amendment enacted after the occurrence of the act or omission that is subject to the proceeding for which indemnification is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such impairment. The amendments effectively overturned a Delaware court decision which held that a company could amend its bylaws to eliminate a former director's right to expense advancement.

It is important to note that D&O policies are not strictly form documents and can be negotiated. Careful attention should be paid to retentions, to the definitions of “claim,” “loss” and “defense costs,” and to policy provisions relating to exclusions, severability and rescission, including potential rescission based on assertions that a company’s financial statements were inaccurate when the policy was issued. Directors should also consider the potential impact of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. Many companies purchase separate supplemental insurance policies covering just the directors and officers individually (so-called “side-A” coverage or, in its more expansive version, “side-A difference-in-condition” coverage) in addition to their normal policies that cover both the company and the directors and officers individually in order to protect directors’ and officers’ rights to coverage and reimbursement of expenses in the event of exhaustion of the company’s primary insurance coverage or, depending on policy language, a bankruptcy of the company.