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Some Thoughts for Boards of Directors in 2007

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The fundamental governance issue confronting corporations in 2007 will be the extent to which shareholders should have the ability to intervene in board actions and influence business decisions that have traditionally been within the purview of the board of directors. This will manifest itself in: (a) debates on executive compensation and the ability to recruit and retain world-class executives, (b) proposals for annual shareholder advisory votes on executive compensation, (c) majority voting proposals and withhold-the-vote campaigns, (d) continuing efforts by activists to achieve proxy access for shareholder-nominees for election as directors, (e) continuing attacks on takeover protections, (f) efforts to mandate shareholder referenda on material decisions, (g) challenges in recruitment and retention of qualified and skilled directors, (h) requests by institutional shareholders for direct communications with directors and (i) demands by activist shareholders for short-term stock performance rather than long-term value creation. As I said in my November 1 memo, "Deconstructing American Business II", the failure to recognize the fundamental importance of properly resolving these issues is a grave threat to American business.

The decision in the Disney case, reaffirming the business judgment rule, has alleviated much of the anxiety about personal liability of directors, but it has not eliminated those concerns. Boards need to keep in mind that the post-Enron accounting and governance reforms have imposed new responsibilities on directors. Directors today must navigate a sea of legal and regulatory requirements, while at the same time guiding the business strategy and performance of the corporation. Doing so successfully is critical to staving off the threat.

In order to avoid an overemphasis on process and at the same time effectively discharge the board's duties to appropriately monitor and supervise the business of the corporation, it is necessary to identify the critical matters on which the board should focus and to create a reasonable program to deal with these matters. The following are recommendations for such a program in today's environment. Obviously, "one size does not fit all" and the board of each corporation can and should tailor procedures to its own circumstances.

The role and duties of the board. The past twenty years have witnessed a transition from the advisory board to the monitoring board. While the board has always had a dual role as a resource and adviser for management, on the one hand, and as an agent of shareholders on the other, in recent years government regulators and activist shareholders, empowered by the reaction to the Enron-type scandals and often in competition with each other, have been tipping this balance with increasing force in favor of the board's role in monitoring compliance with legal and accounting rules. But it is still generally acknowledged that a combination of the two is necessary, and that only a collegial board can function effectively over the long run. To be truly effective, each board must find the right balance between monitoring

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

An excellent statement of the board's dilemma is found in a recent article by the renowned economist, Professor Bengt Holmstrom of the Massachusetts Institute of Technology:

> Boards are charged with many different tasks, creating tensions between some of them. Keeping an eye on executive pay, for instance, has historically not been one of the board's primary tasks, I think for a good reason. If the main task of the board were to make sure executives do not abscond with corporate funds, then the board should consist of accountants and lawyers who are good at detecting fraud and other illegalities.
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> The reason CEOs and other people with business expertise sit on boards is that they are better placed to learn about the firm's strategy and understand how management thinks about it. This information is especially important when a CEO retires or when the firm runs into trouble and the board needs to figure out whether the current management has what it takes to get out of the trouble. These are crucial times for the board. The board's primary duty is to make sure it has the information necessary to make these important decisions and that it uses the information with judgment. Few people understand how challenging the task is. The degree of uncertainty is high. The cost of staying informed is high. The price of making an error is high. . . .
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> It is crucial to gather such information in time and not start when the crisis hits. Getting information requires a trusting relationship with management. If the board becomes overly inquisitive and starts questioning everything that the management does, it will quickly be shut out of the most critical information flow — the tacit information that comes forward when management trusts that the board understands how to relate to this information and how to use it. Management will keep information to itself if it fears excessive board intervention. A smart board will let management have its freedom in exchange for the information that such trust engenders. Indeed, as long as management does not have to be concerned with excessive intervention, it wants to keep the board informed in case adverse events are encountered. Having an ill-informed board is also bad for management, since the risk of capricious intervention or dismissal increases.

***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 will form the culture of the corporation and permeate the corporation's relationship not only with investors, but also with employees, customers, suppliers, local communities and other constituents. If the CEO and senior management are not personally committed to high ethical standards, principles of fair dealing, full compliance with legal requirements and resistance to Wall Street pressures for short-term results, no amount of board process or corporate compliance programs will protect the board from embarrassment. The board should participate in creating the corporate culture and should periodically review with the CEO what the CEO and senior management are doing to set the right example and how it is being communicated to all employees and other constituents of the corporation. Transparency is key: the board's vision for the corporation, including its commitment to ethics and zero tolerance for compliance failures, should be set out in the annual report and communicated effectively within the corporation.

CEO selection and succession planning. The CEO plays the key role in the management of the corporation. In addition to helping to set the tone at the top, the other critical job of the board is selecting and evaluating the CEO and the senior executive leadership of the corporation and planning for their succession. There are no prescribed procedures for planning succession and selecting the CEO, and a board should fashion the principles and procedures it deems appropriate. In fulfilling its CEO selection and succession function, the board should recognize that by itself competence is not enough. The integrity and dedication of the CEO is critical in enabling a board to meet all of its responsibilities. In large measure, the fate of each of the board and the CEO is in the hands of the other. In choosing a CEO, the board should not feel required to conduct a search of outside candidates. A proven well-qualified internal candidate, who is intimately familiar with the corporation's business and culture, is frequently the best choice.

Crisis management. Perhaps the most important test of a board comes in times of crisis. Boards need to be proactive in taking the reins in the context of any governance, compliance or business crisis affecting the corporation. At the same time, boards need to be cautious not to overreact to any given situation and thereby precipitate or exacerbate a crisis. Boards have responded to recent crises with varying degrees of success. Many boards have functioned quite well in taking a careful measure of the situation and then putting in place the right procedures for obtaining the necessary information about the issues facing the corporation, developing the right strategies for responding to the situation and rectifying any management, disclosure or legal/compliance deficiencies. Others, however, appear to have either overreacted, or to have placed matters in the hands of lawyers, accountants and other outside experts, and thereby lost control of the situation to those outsiders. And, in some instances, the crises themselves appear to have arisen in large part from the failure of management and the board to be proactive in reacting to earlier warning signs.

The first decision a board must make during a crisis is to decide whether the CEO should lead the corporation through the crisis. If the CEO is part of the problem or is otherwise compromised or conflicted, someone else – often one of the other directors – should take a leadership role. If the CEO is not compromised or conflicted, the CEO should lead the corporation's response to the crisis.

Each crisis is different and it is difficult to give general advice that will be relevant to any particular crisis without knowing the facts involved. That said, in most instances when a crisis arises, the directors are best advised to manage through that crisis as a collegial body working in unison. While outside advisors (counsel, auditors, consultants and bankers) can play a very useful and often critical role in gathering the relevant facts of a given situation and in helping to shape the right result, the directors should maintain control and not cede the job of crisis management to the outside advisors. And, while there may be an impulse to resign from the board upon the discovery of a crisis, directors are best served in most instances if they stay on the board until the crisis has been fully vetted and brought under control.

In my November 1 memo, I said that one of the most significant problems facing boards today is:

> The proliferation of special investigation committees of independent directors, with their own independent counsel, to look into compliance and disclosure issues. In today's charged environment, compliance and disclosure problems lead almost inexorably to independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisors. Risk-averse auditors, spurred by the strict standards of the SEC, frequently demand investigations, while the media and many lawyers create the impression that best practices require independent investigations even outside of the purview of the SEC. These time-consuming investigations further distract independent directors from their role as strategic advisors, sour relationships between independent directors and management, and in extreme cases result in the lawyers for the special-committee hijacking the company and monopolizing the attention of directors and senior management.

Monitoring performance. While the corporation laws literally provide that the business of the corporation is to be managed by or under the direction of the board of directors, it is clear that the board's function is not to actually manage, but to oversee the management of the corporation by monitoring the performance of the CEO and other senior officers. To enable the board to monitor performance, the board and management together need to determine the information the board should receive. Here, "less can be more." The board should not be overloaded with information. It is not necessary that the board receive all the information that the CEO and senior management receive. The board should receive the information that it determines to be useful to it. The board should consider annually whether it is receiving the appropriate information and make adjustments as necessary. Basically, the board should receive financial information that 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. If an article or report raises compliance, performance or other issues, the board should request a satisfactory explanation of the issues raised in the publication, including, if appropriate, what is being done to correct the situation. By tracking these reports and articles, the board will avoid not only unpleasant surprises but also the possibility of being accused of ignoring problems that were known to others and which could have been known by the directors.

Monitoring compliance. As with performance, the board should monitor legal and regulatory compliance by the corporation. The board does not have a duty to ferret out compliance problems. It does, however, have a duty to implement appropriate monitoring systems, and to take appropriate action when it becomes aware of a problem and believes that management is not properly dealing with it. In normal situations, it is sufficient for the board to review compliance matters and litigation semi-annually. This may be done directly by the board or through the audit committee or another committee. However it is done, it is a desirable practice for the board or the committee to meet regularly in executive session with the general counsel of the corporation. Where there is a serious investigation or litigation that is being handled by outside counsel, such counsel should also report to the board or the committee. In addition, the board should oversee an annual review of the corporation's compliance and governance programs and its information and reporting systems and receive the opinion of the general counsel as to their adequacy. In performing its monitoring function, the board should be sensitive to "red flags" and "yellow flags." When such flags are raised, the board should observe and investigate as appropriate and document its monitoring activities in minutes that accurately convey the time and effort directors devote to decision-making, even when the outcome is to take no action. The federal sentencing guidelines also promote comprehensive compliance procedures and careful monitoring by requiring that directors be knowledgeable about compliance programs, be informed by those with day-to-day responsibility over compliance and participate in compliance training. The guidelines provide that an effective compliance program monitored by the board may be a mitigating factor in a prosecutor's decision whether or not to charge a company with wrongdoing.

Effectiveness of the board. It has been suggested that a board's failure to allot adequate time to carry out its duties could call into question whether it had acted in good faith. In addition to scheduling regular board and committee meetings to provide ample time for the regular business of the board, boards should consider the desirability of an annual two-to-three-day board retreat with the senior executives at which there is a full review of the corporation's financial statements and disclosure policies, strategy and long-range plans, budget, the company's mission, succession planning and current developments in corporate governance. Corporations should also provide comprehensive orientation for new directors so as to acquaint them with the corporation's strategy, long-range plans, financial statements, properties and operations, corporate governance guidelines and senior executives. The annual retreat could satisfy a major portion of such an orientation. In addition to orientation, corporations should provide education programs for continuing directors, both to enhance their skills as directors as well as to help them stay abreast of regulatory and corporate governance developments.

Corporate strategy. Approval of the corporation's long-term strategy is a key board function. Strategy should be formulated initially by management and then developed fully in an interactive dialogue with the board. Many companies find it productive to include an annual strategy review in a board retreat of the type described above.

Separating roles of chairman and CEO; lead director. Most American companies have traditionally had a single individual who combines the roles of both chairman of the board and CEO. While there is a growing effort by shareholder activists calling for the separation of these roles, most institutional shareholders and their advisors leave this matter to the discretion of the board, provided that there is an independent director who presides over executive sessions of the board. While there is no formal requirement in the NYSE rules or in the Sarbanes-Oxley Act that a company have a lead director, the independent directors should have a leader who is not also the CEO. Whether he or she is called the lead director, the non-executive chair or the presiding director, this leader should have the following key roles: (1) be available to discuss with the other directors any concerns they may have about the company and its performance and relay these concerns, where appropriate, to the full board; (2) be available to consult with the CEO regarding the concerns of the directors; (3) be available to be consulted by any of the senior executives of the company as to any concerns the executive might have and

(4) preside at executive sessions of the board. In order to be effective, he or she should be a senior person who is highly respected and regarded by the CEO and the other directors. The lead director is not an officer and would not have any of the formal duties of a chairman of the board, but he or she is the director who would assume leadership of the board if a need to do so should arise. A company might either have a single individual designated as a lead director or have a presiding directorship through which the committee chairs rotate. If a lead director is designated, the NYSE requires his or her name to be disclosed in the annual proxy statement. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session.

***Independence*.** The emphasis on board independence should not cause the board to lose sight of the importance of promoting the sort of board dynamic that can most effectively lead to a well-functioning board and an effective partnership between the board and senior management. Although the NYSE requires only that a majority of the board be independent, today most boards have only one or two directors who are not independent: the CEO and maybe one other current or former officer. Nevertheless, many of the shareholder advisory services, institutional investors and academic gadflies are continuing to urge (in some cases, demand) that all directors other than the CEO be independent and that social and philanthropic ties among and between the directors and the CEO be considered as impugning, if not destroying, independence. These types of requirements and restrictions are the antithesis of the kind of collegiality and relationship with the CEO that is necessary for the board and CEO together to promote the appropriate tone at the top, to agree on the corporate mission and work collectively to enhance the corporation’s business. What companies need are directors who possess sufficient character and integrity to allow them to make judgments unaffected by considerations affecting themselves or those with whom they have relations. The concept of directors as remote strangers and the board as the agency for the discipline of management, rather than as advisor to management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance. The tension between the new norms of independence and the overarching objective of better performance, unless modulated and maintained in perspective, can cause the former to overwhelm the latter.

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

***Nomination of director candidates*.** Shareholders can propose potential director candidates to the nominating committee, and the nominating committee has a duty to consider all *bona fide* candidates and to nominate directors that it believes will best serve the interests of the company and its shareholders. In evaluating potential director candidates, whether they are proposed by management or shareholders, the nominating committee should use the same fundamental criteria. The foremost criterion is competence: boards should consist of well-qualified men and women with appropriate business and industry experience. The second important consideration is collegiality. A balkanized board is a dysfunctional board; a board works best when it works as a unified whole, without camps or factions and without internal divisions. The nominating committee should also try to ensure that the board consists of individuals who understand and are willing to shoulder the time commitment necessary for the board to effectively fulfill its responsibilities. To this end, companies should consider including in their corporate governance guidelines policies limiting the number of boards on which a director may sit. Those guidelines should also address director tenure. Companies should consider whether it would be advisable for them to impose term or age limits on directors. 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.

There is no formula for the perfect board. Strong, independent directors are essential to proper board functioning, but so too are elusive qualities such as collegiality, sense of common purpose, energy, industry knowledge, business sense and trust. Diversity is also important. The nominating committee should have the flexibility to determine the mix of qualifications and attributes that is best suited to the specific needs of the corporation.

Despite the great advantages of a nominating committee that can give thoughtful consideration to potential director candidates, the traditional nominating system is under attack by activists who believe that shareholders should have greater power to nominate directors. The principal goal of this movement has been "proxy access," which would require that, under certain circumstances, companies include in their proxy statements and on their forms of proxy the names of shareholder-nominated director candidates. This would allow shareholders to propose their own candidates without either the approval of the nominating committee or the expense of a proxy fight. While a 2003 SEC proposal to allow proxy access never gained enough support to become a final rule, recent events, including a court decision requiring AIG to include in its proxy statement a shareholder bylaw proposal allowing proxy access, have given new life to the activists' campaign for this kind of proxy access requirement. In response to the AIG decision, the SEC announced that it will consider proxy access at a December 2006 meeting. Proxy access would increase the frequency of contested director elections and deter qualified people from serving on public company boards, divert management's attention from the business to electoral campaigning, encourage short-term thinking, and lead to a rise in director candidates representing special interests rather than seeking value for all shareholders. It should continue to be rejected and opposed.

<u>Confidentiality and the role of directors outside the boardroom</u>. A board should function as a collegial body, and directors should respect the confidentiality of all discussions that take place in the boardroom. Confidentiality is essential for an effective board process and for the protection of the corporation and its stockholders. Moreover, directors generally owe a broad legal duty of confidentiality to the corporation with respect to information they learn about the corporation in the course of their duties. Maintaining confidentiality is also essential for the protection of the individual directors, since directors can be responsible for any misleading statements that are attributable to them. Even when a director believes the subject matter of his or her statements is within the public domain, it is good practice for individual directors to avoid commenting on matters concerning the corporation. A director who receives an inquiry with respect to the corporation from outside the corporation may or may not have all of the relevant information and his or her response could involve the corporation, as well as the director, in a disclosure violation. Directors also should respect the role of the CEO as the chief spokesperson for the corporation. They should generally not engage in discussions with outsiders concerning corporate business unless specifically requested to do so by the CEO or the board. Where it is necessary for outside directors to speak on behalf of themselves or the corporation, here too it is best for one member of the board to be designated as the board's spokesperson. Where a board has a non-executive chairman or a lead director, under certain circumstances it may also be appropriate for the chairman or lead director to speak on behalf of the corporation, particularly within the ambit of those directors' special roles. In the ordinary course, all such matters should be handled in close consultation with the CEO so as to avoid confusion in the corporation's public statements and posture.

The scandal arising from the Hewlett-Packard leak situation demonstrates the importance of these principles. When a board is confronted with leaks, it should first and foremost reiterate the basic principles described above. If it is apparent that a particular director has been revealing confidential information, the full board (or a committee of the board) should speak to that director and advise him or her that the penalty for breaching confidentiality is not being renominated to the board. If it is not apparent who has revealed confidential information, the problem should be discussed by the full board, with counsel present, and the board should decide on how to deal with the problem. In most cases this has proved to be effective. In the rare cases where it is not effective, an agreement by all directors to be interviewed by counsel should prove effective. Of course, anything beyond this, and any investigative action taken without the knowledge of the board, carries the potential of a Hewlett-Packard-type scandal.

The basic principles outlined above also have application in responding to public pension funds that demand to meet not just with management but with independent directors to express their views with respect to performance, governance, social issues and political matters. While boards may reasonably decide to agree to such meetings to avoid high-profile public battles with activist shareholders, they should take care to coordinate such meetings with the full board and management to avoid confusion or contradiction in the company's public posture.

Committees of the board. The NYSE requires a listed company to have an audit committee, a compensation committee and a nominating committee, each comprised solely of independent directors. The SEC imposes further expertise requirements on members of a company's audit committee, as well as disclosure requirements intended to prevent "interlocking" compensation committees between public companies. The requirement that a committee be composed of only independent directors does not mean that the CEO (and other employees) should be excluded from all the discussions or work of the committee. Indeed, it would be virtually impossible for the committees to function effectively without the participation of the CEO. All compensation matters, including the CEO's compensation, should be discussed with the CEO, and all governance and director nomination matters should be discussed with the CEO. While the final determination is that of the committee, there is no restriction on full discussion with the CEO. The committees have the authority to retain consultants, but there is no requirement that the compensation committee retain a compensation consultant or that the nominating committee retain a search firm, if the committee believes that it does not need such assistance. Indeed, shareholder activists and newspaper commentators have recently criticized the use of compensation consultants, and while committees may continue to use such consultants if they believe that they provide a valuable service, they should be careful not to over-rely on consultants and to exercise their own independent judgment on all matters that come before them.

All companies, as part of their broader governance reviews, should carefully consider which directors satisfy the requirements for service on committees. Questionnaires may be used to determine and document both independence and qualification for committee assignments. In addition to the core committees, boards may wish to establish additional standing committees to meet their ongoing governance needs, such as a risk management committee (if this function is not being performed by the audit committee), a compliance committee, or a committee on social responsibility. Boards may also use special committees from time to time to deal with conflict transactions (such as a management buyout) or other major corporate events (such as shareholder litigation or a hostile takeover bid) or to address particular special investigations or projects. While the use of special committees is appropriate and useful in many circumstances, such committees are also often used in situations where it might be best to keep the matter in question before the full board (or before all of the outside members of the full board). Special committees can sometimes become divisive in sensitive situations, and there is a risk that the special committee and its outside advisors may take a matter in a direction that would be different than that desired by the full board. Especially in matters of great sensitivity, it is often preferable for all directors (or at least all outside directors) to remain active in dealing with the matter.

The work of the board will be facilitated by establishing the appropriate relationship between the board as a whole and each of its committees, so that the work of the committees is neither duplicated nor ignored by the board as a whole. In a regulatory environment where audit, compensation, and nominating committees must be composed solely of independent directors, and where those committees are tasked with ever increasing responsibilities, it is particularly important that boards avoid balkanization and keep the full board, as well as management, apprised of the significant actions of these committees. In order to enable both the board and its committees to deal with any special problems that may arise in the course of performing their duties, the board and its standing and special committees should have the authority to engage independent advisors where appropriate. That said, this authority should be used sparingly; as a general rule, a board or board committee should resort to it only when there is a real conflict or some other genuine need for independent or specialized advice. More often than not, a corporation's own general counsel or CFO can provide more pertinent advice and insight than that available from outside sources; so too can outside counsel that has a substantial continuing relationship with the corporation and its board, rather than "independent" counsel that has had no such relationship.

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

Executive sessions. The NYSE requires the non-management directors to meet in regularly scheduled executive sessions of the board in which management is not present. Each board should determine the frequency and agenda for these meetings. They provide the opportunity for meaningful review of management performance and succession planning. In addition, they are a safety valve to deal with problems. They should not be used as a forum for revisiting matters already considered by the full board. The executive sessions should not usurp functions that are properly the province of the full board, and boards should be careful that use of executive sessions does not have a negative effect on board collegiality and relations with the CEO.

Charters, codes, guidelines and checklists. The audit, compensation and nominating committees are required to have charters. The corporation is required to have a code of ethics and a set of policies and procedures for reviewing related party transactions. The board is required to have corporate governance guidelines and, as noted, there is no end to the number of recommended checklists designed to assist corporations in complying with Sarbanes-Oxley, SEC regulations and NYSE rules. All of these are to some extent useful in assisting the board and committees in performing their functions and in monitoring compliance. However, there is a tendency to expand the scope of charters and checklists to the point that they are counterproductive. If a charter or checklist requires review or other action and the board or committee has not taken that action, the failure may be considered evidence of lack of due care. The creation of charters and checklists is an art that requires experience and careful thought. It is a mistake to copy the published models. Each corporation should tailor its own charters and checklists, limiting them to what is truly necessary and what is feasible to accomplish in actual practice. In order to be "state of the art," it is not necessary that the corporation have everything someone else has. Charters and checklists should be carefully reviewed each year to prune unnecessary items and to add only those items that will in fact help directors in discharging their duties.

The audit committee. The post-Enron reforms have invested the audit committee with a special role in corporate governance. In large measure, the audit committee has become the principal means by which the board monitors financial and disclosure compliance. Accordingly, boards should carefully select audit committee members and, to the greatest extent possible, be attuned to the quality of the audit committee's performance. In view of the audit committee's centrality to the board's duties of financial review, it is also important for the board as a whole to receive periodic reports from the audit committee and to be comfortable that the audit committee, the auditors and management are satisfied that the financial position and results of operations of the corporation are fairly presented.

Minutes. Careful and appropriate minutes should be kept of all board and committee meetings. The minutes should reflect the discussions and the time that was spent on significant issues, both in the meeting and prior to the meeting. The minutes should also reflect all those who were present at the meeting and the matters for which they were present or recused. Increasingly, courts and regulators have raised questions about the amount and scope of attention that was spent on a matter when the minutes did not adequately support the recollection of the directors as to what transpired. 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.

Executive compensation. This is today's most high-profile corporate issue and a major focus of shareholder activism. Virtually everyone who has weighed in on this issue agrees that executive compensation should be aligned with long-term corporate performance and shareholder value. In addition, most companies, including well-performing ones, need to engage in recruiting and retention efforts to attract, and prevent the loss of, qualified individuals. There is a wide spectrum of views as to how to achieve the agreed objectives. The only really useful advice is thoughtful process, full disclosure and recognition by the compensation committee that it should not be deterred by media and gadfly attention from doing what it feels is in the best interests of the corporation. In the final analysis, nothing is more important to the success of the corporation than its ability to recruit and retain world-class executives.

In July 2006, the SEC promulgated new rules that require increased disclosure of executive compensation. The rules call for a new narrative compensation disclosure, called the "Compensation Discussion & Analysis," intended to give shareholders an overview of the company's compensation philosophy and the important decisions reflected in its compensation numbers. Other revised disclosure requirements include a description and quantification of termination and change-of-control payments to named executive officers (including tax gross-ups); disclosure of actuarial value of pension benefits and increased disclosure of components of non-qualified deferred compensation; and enhanced tabular disclosure of option grants and narrative discussion of option grant methods and timing. Complying with the rules and documenting the process for doing so in a manner designed to create a record to support the disclosures and the concomitant certification will be an arduous task involving a number of people, including the members of the board and the compensation committee.

In addition to the new disclosure rules, the SEC is also continuing its ongoing investigations of "option backdating" and other option grant practices. In light of these investigations, the compensation committee should review its procedures and meet with corporate counsel to be sure it is in full compliance with all requirements.

It is expected that in 2007 activists will submit proxy resolutions to require shareholder advisory votes on executive compensation to a number of corporations. Such a requirement is designed to usurp the power of the compensation committee to use its judgment in determining executive compensation and should be strongly resisted.

Board, committee and CEO evaluations. The NYSE requires annual evaluations. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants have also established an advisory service in which they meet with the board and committee members to lead them through the evaluation process. Each board needs to decide how best to conduct its own evaluation. In making the decision, it should be noted that it is not required that the board receive outside assistance and it is not required that multiple-choice questionnaires and/or essays be the means of evaluation. If a board prefers to do the evaluation by discussion at meetings, that is perfectly acceptable. It should also be noted that documents and minutes created as part of the evaluation process are not privileged and care should be taken to avoid damaging the collegiality of the board and creating ambiguous records that may be used in litigation against the corporation and the board.

Shareholder activism. The past five years have witnessed a significant escalation in shareholder-sponsored precatory proxy resolutions and the high level of shareholder support that they are able to command. On some issues, mostly related to takeover defenses, shareholder proposals now routinely receive majority support. One of the explanations for such shareholder support is the demise of "case-by-case" voting by institutional shareholders. Today, institutional shareholders typically subscribe to the services of proxy voting advisors, such as ISS, to provide analysis or advice with respect to shareholder votes. These proxy voting advisors publish proxy voting guides setting forth blanket voting policies on a variety of common issues that are frequent subjects of shareholder proposals. Institutional shareholders typically do not review individual shareholder proposals on a company-by-company basis. Instead, they rely heavily on these proxy voting guidelines, regardless of an individual company's performance or governance fundamentals. As a result, many shareholder votes are foreordained by a voting policy that is applied to all companies without reference to the particulars of a given company's situation.

In dealing with shareholder proposals, the board should take into account the corporation's shareholder relations programs and consider whether it is appropriate for management or even the board to have greater interaction with shareholders. Where the corporation has significant performance or compliance issues, direct contact between institutional shareholders and non-management directors may forestall a proxy initiative by shareholders. In addition, the corporation should weigh carefully opposition to shareholder proxy resolutions that can be accommodated without significant difficulty or harm to the company. Today, it is prudent to do a risk-reward analysis of shareholder resolutions, rather than to routinely oppose them. By paying serious attention to shareholder proposals, and by being proactive in shareholder communications and disclosure, boards are most likely to create the right environment for acting on shareholder resolutions even when the ultimate determination may be to reject them.

Majority voting in director elections. Over the past two years activist shareholders have focused particular attention on efforts to persuade corporations to adopt majority voting for election of directors. Many companies have followed Pfizer in amending their corporate governance guidelines to require that any director who receives a majority of withheld votes submit his or her resignation to the board, leaving the outcome in the hands of the board. Precatory shareholder proposals urging companies to adopt majority voting bylaws achieved significant success in the 2006 proxy season, although companies that had already adopted Pfizer-style guidelines were usually able to defeat such proposals. ISS usually recommends a vote in favor of majority voting bylaws even for companies that have adopted Pfizer-type governance guidelines. In 2006 the Delaware legislature adopted amendments to the Delaware General Corporation Law that allow shareholders to adopt amendments to a company's director election bylaws that cannot be amended by directors, further increasing the pressure on companies to accede to demands for majority voting. It is clear today that majority voting will become universal. In light of the ISS position and in an effort to avoid shareholder proxy proposals, it is advisable for companies to adopt proactively a majority voting bylaw.

A number of other recent developments will also magnify the power of stockholder activists in director elections. NYSE rules do not allow discretionary broker voting in contested or "non-routine" situations. The NYSE has in the past taken the position that withhold the vote campaigns are not contested situations. However, the NYSE has now amended its rules so that election of directors will be considered a "non-routine" matter, thus eliminating discretionary broker voting in director elections. Shareholder activism may be further aided by a proposed SEC rule to permit Internet distribution of proxy statements. The proposal would make it less expensive for activist shareholders, who are dissatisfied with incumbent directors, to wage withhold-the-vote campaigns or full proxy contests for board representation.

Balancing short-term performance and long-term success. Activist shareholders, armed with the threat of withhold-the-vote campaigns against directors, can be expected to exacerbate the tension between short-term performance and long-term success of the corporation. This is currently being manifested in the expanding demands by hedge funds for companies to undertake massive stock buybacks funded by a sale of assets or to sell the entire company. While different in form, this hedge fund pressure raises management and board issues similar to those created by the pressure to give quarterly earnings guidance and then meet the targets. The short-term, long-term debate will be a major focus in boardrooms of companies confronted by demands for stock buybacks or sale of the company upon threat of a withhold-the-vote campaign or a proxy fight. The critical factor in these confrontations will be whether the major institutional investors will support companies that have reasonable plans and prospects for long-term success and growth or whether they will insist that those plans be truncated for a quick increase in the price of the stock. Directors should periodically review the company's plans for dealing with an attack by activists.

Personal liability of directors. The 2005 decision of the Delaware Chancery Court in the Disney case, upheld by the Delaware Supreme Court in 2006, reaffirmed that the business judgment rule is alive and well. The Disney decision also delineated the scope of protection of directors against personal liability for claimed breach of fiduciary duty. Negligence — that is, a failure to use due care — will not result in personal liability unless the director failed to act in "good faith." The Supreme Court ruled that a director fails to act in good faith if his or her conduct is motivated by "an actual intent to do harm" or, alternatively, if it demonstrates an "intentional dereliction of duty, a conscious disregard for one's responsibilities." The Court ruled that a director fails to act in good faith when the director (1) "intentionally acts with a purpose other than that of advancing the best interests of the corporation," (2) "acts with intent to violate applicable positive law," or (3) "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The Chancery Court also said that although it strongly encourages directors to employ best practices of corporate governance, as those practices are understood at the time a board acts, directors will not be held liable for failure to comply with "the aspirational ideal of best practices." In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self interest, and in so doing they will be free from "*post hoc* penalties from a reviewing court using perfect hindsight."

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

In a recent speech John White, Director of the SEC Division of Corporation Finance, advised directors:

> As you all know, you generally must sign your company's annual report on Form 10-K. And if that report is incorporated into a subsequent offering document for a public issuance of securities by your company, then you will have liability for the disclosures in that document with regard to that offering. The [SEC] review process and the comment letters we issue are there for you to look at and understand. I would urge you not to overlook them. If I were a director, I would want to make sure I receive a copy of each of my company's comment letters and, equally important, the responses my company submitted. Understand the questions the [SEC] has asked, the answers the company has provided and the revisions it has made for its filings. Use that understanding, then, to help set the benchmarks for your company's future disclosures. I do not mean to suggest that directors need to be at the front lines of preparing their companies' public filings. You do need to understand your company's disclosures, however, and this can be one more tool in your toolbox to do that. It will not do the whole job for you, but it can help.

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

<u>Reliance on advisors</u>. The basic responsibility of directors is to exercise their business judgment to act in a manner they reasonably believe to be in the best interests of the corporation and its shareholders. In discharging these obligations, directors are entitled to rely on management and the advice of the corporation's outside advisors. The board should make sure that the corporation's legal counsel, both internal and external, and auditors, both internal and external, have direct access to the board, if ever needed.

The board should also guard against overuse of outside advisors. In my November 1 memo, I note that a significant problem today is:

> The demeaning effect of the parade of lawyers, accountants, consultants and auditors through board and committee meetings. A corollary of the transformation of the role of the board from strategy and advice to investigation and compliance is an increased reliance on experts in the boardroom. While it is of course salutary for boards to be well advised, over-reliance on experts tends to reduce boardroom collegiality, distract from the board's role as strategic advisor, and call into question who is in control – the directors or their army of advisors . . . .

Director compensation. Director compensation is one of the more difficult issues on the corporate governance agenda, as the need to appropriately compensate directors for their time and efforts must be balanced against the risk that generous compensation may raise an issue of independence. Over the last few years, the former factor has predominated, and director pay has increased significantly as more is expected of directors in terms of time commitment, responsibility and exposure to public scrutiny and potential liability. The compensation committee should determine the form and amount of director compensation with appropriate benchmarking against peer companies. It is legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time, including special committees formed to review major transactions or litigations. The Council of Institutional Investors and other shareholder advisory organizations have recognized the need for adequate director compensation. The SEC's revised disclosure rules now call for enhanced tabular and narrative disclosure of all director compensation, including cash fees, equity awards, and deferred and other compensation.

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

Whistle-blowers. Boards, and in particular audit committees, are required to establish procedures to enable employees to confidentially and anonymously submit concerns they might have regarding the company's accounting, internal controls or auditing matters. In addition, companies are subject to potential civil, and in some cases criminal, liability if they can be shown to have taken retaliatory action against a whistle-blower who is an employee. In responding to these constraints, there can be a temptation to establish a special committee of independent directors to investigate every single whistle-blower complaint. This temptation should be resisted in favor of a procedure that filters whistle-blower complaints, as such investigations can be extremely disruptive and can create an unnecessary crisis. The SEC has urged companies to appoint a permanent ombudsman or business practices officer to receive and investigate complaints. Boards should ensure the establishment of an anonymous whistle-blower hotline and a well-documented policy for evaluating whistle-blower complaints, but they should also be judicious in deciding which complaints truly warrant further action.

Review of controls and risk management. The board should — whether directly or through the audit committee — review whether management has adopted and implemented proper risk assessment and risk management policies and procedures. The risks that a company might face include business risks (such as risks posed by defective products, violation of environmental requirements, accidents and political changes), financial risks (such as risks posed by financial asset composition, derivative securities, structured financing, contingencies and guarantees), legal risks and reputation risks. The board should review whether each category of risk is addressed by the company's risk management procedures.

It is an important responsibility of management to establish and maintain an adequate internal control structure and procedures for financial reporting and compliance with law, including applicable SEC disclosure requirements. The SEC rules implementing Section 404 of the Sarbanes-Oxley Act require management to prepare reports on internal controls and the independent auditor to attest to those reports as part of its audit. The rules also call for a quarterly evaluation and certification by management of a company's internal controls and procedures for financial reporting. Directors should pay careful attention to whether management has invested sufficient resources and energies in the company's control and risk monitoring and management infrastructure. The board (through the audit committee) should satisfy itself (by getting regular reports from the management and the internal auditor) that the company's existing internal control systems provide for the maintenance of financial records in a way that permits preparation of financial statements in accordance with GAAP and gives "reasonable assurance" of accuracy in financial reports, and that management designs and supervises processes that adequately identify, address and control compliance risks. That said, while "reasonable assurance" is a high standard, it is not an absolute. Boards should seek to make sure that the company addresses any deficiencies that are discovered, but should avoid overreacting to such deficiencies.

Major transactions. Board consideration of major transactions, such as acquisitions, mergers, spinoffs, investments and financings, needs to be carefully structured so that the board receives the information necessary in order to make a reasoned decision. This does not mean that outside advisors are necessary, even for a very large transaction. If the corporation has the internal expertise to analyze the requisite data and present it in a manner that enables the board to consider the alternatives and assess the risks and rewards, the board is fully justified in relying on the management presentation without the advice of outside experts. There is no need for the board to create a special committee to deal with a major transaction, even a hostile takeover, and experience shows that a major transaction not involving a specific conflict of interest is best addressed by the full board. Management should build a strong foundation to support a major transaction, including an appropriate due diligence investigation. The board should have ample time to consider a major transaction, including in cases of complicated transactions and agreements a two-step process with the actual approval coming only after an initial presentation and the board having had time for reflection.

Related party transactions. Generally boards are not comfortable with related party transactions and today most companies avoid them. However, there is nothing inherently improper about transactions between a corporation and its major shareholders, officers or directors; such transactions are often in the best interests of a corporation and its shareholders, offering efficiencies and other benefits that might not otherwise be available. It is entirely appropriate for an informed board, on a proper record, to approve such arrangements through its disinterested directors. As a matter of compliance and best practices, however, and particularly in the current environment, the board should give careful attention to all related party transactions. Full disclosure of all material related party transactions and full compliance with proxy, periodic reporting and financial footnote disclosure requirements is essential.

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

Indemnification, exculpation and D&O coverage. The Disney decision notwithstanding, shareholder litigation against directors continues. All directors should be indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of D&O insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest coverage available. Having in place governance procedures that are responsive to the recent legislative and regulatory initiatives and that reflect best practices, and having a robust record reflecting strong, good faith efforts to adhere to those procedures, will be helpful in assuring that a court respects the applicability of exculpatory charter provisions.

D&O coverage provides a key protection to directors. While such coverage has become more expensive in recent years, it is still available in most instances and remains highly useful. It is important to note that D&O policies are not strictly form documents and can be negotiated. Careful attention should be paid to retentions and exclusions, particularly those that seek to limit coverage based upon a lack of adequate insurance for other business matters, or based on assertions that a company's financial statements were inaccurate when the policy was issued. Directors should also consider the potential impact of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, many companies purchase separate supplemental insurance policies covering just the directors and officers individually (so-called "side-A" coverage) in addition to their normal policies which cover both the company and the directors and officers individually.