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SHAREHOLDER ACCESS

A "Common Sense" Approach to Shareholder Access: A Modest Proposal for an Access Bylaw

By John C. Wilcox

For more than five years issuers and investors have been debating whether shareholders should have the right to nominate board candidates for inclusion in the company's proxy. This so-called "access" right is rooted in a longstanding concern that, short of a proxy contest, procedures for nominating directors at US companies are not sufficiently accessible to shareholders. Since corporate legitimacy rests squarely on the integrity of the director selection process and a meaningful shareholder vote, the validity of an access right is difficult to challenge.

The Securities and Exchange Commission attempted to find a workable approach to access in 2003 with proposed Rule 14a-11, a fine-tuned but complicated concept that failed to attract support from either investors or corporations. Efforts to define and implement an access right later shifted to the shareholder proposal process, further polarizing the views of companies and investors. Following a controversial interpretation of Rule 14a-8(i)(8) by

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the SEC earlier this year, the fight over access has been suspended for at least the duration of the current proxy season. The issue will probably not be taken up again until after the Presidential election.

This intermission may turn out to be a blessing in disguise, provided that companies and investors are willing to use the time to cool down, reevaluate the pros and cons and seek constructive ways to develop a moderate and flexible form of access acceptable to both sides. Based on past experience with Rule 14a-11 and subsequent SEC initiatives, federal rule-making is probably not the most effective way to establish an access right. Following the path that led to acceptance of the majority vote standard in director elections, access might be more easily derived through a careful analysis of its implications under state corporate law.

Start with a Dispassionate Analysis of Shareholder Access

A dispassionate analysis of access should start with an understanding of the preferences and limited goals of long-term institutional investors. Their agenda does not include election of special-interest directors, back-door proxy contests or advocacy for causes unrelated to performance enhancement and long-term value creation. They envision access as a new engagement tool—a new step on the ladder of shareholder rights—that is more aggressive than precatory shareholder proposals or votes against directors, but less aggressive than a short-slate election, control contest or takeover bid.

Access, as conceived for use by long-term investors, would function as a potent but narrowly defined accountability mechanism applicable primarily to companies with serious strategic, governance or performance problems. The need for such a tool has become urgent in recent years, as shareholders have confronted deep-rooted governance and performance problems at US companies. Abusive compensation practices, ill-conceived mergers and acquisitions, improper accounting, neglect of succession planning, self-dealing, conflicts of interest and ethical lapses have occurred at many companies. The three remedies currently available—divesting stock, waging a proxy contest, or developing an engagement program—have in many cases failed to provide efficient or timely means for institutional investors to respond to these crises.

Selling or divesting shares of troubled companies is usually not an option for large, indexed long-term investors whose performance is measured against market benchmarks. From an economic viewpoint, divestment can be particularly inappropriate when a portfolio company's stock price is depressed by the very problems the investor seeks to remedy.

Proxy contests present numerous obstacles and potential conflicts for institutional investors. Because of the economic and fiduciary constraints involved in managing large portfolios, institutions may not be in a position to take on the organizational demands, costs, exposure, time commitment, legal complications, disclosure requirements, liability concerns and other risks and obligations associated with waging a proxy fight. For economic reasons investment managers are often rationally reluctant to further disrupt an already troubled company with a discounted stock value. The free-rider problem is often perceived as an obstacle. In addition, institutions may not support the goals of short-term activists willing to initiate proxy contests.

Active engagement with the boards and managers of targeted companies has always been the remedy of choice for long-term investors. Engagement has proven extremely effective as a means to promote shareholder rights, improve governance practices, increase director accountability and promote policy changes. But the slow pace of traditional engagement campaigns makes them less useful to "jump-start" companies that are languishing or ignoring their problems.

A Proposed Shareholder Access Bylaw

Conceptually, an access right would provide shareholders with a stepped-up form of engagement—a new accountability mechanism for dealing with seriously troubled companies. By bringing shareholder concerns directly into the boardroom, access would inject a note of heightened urgency and promote the kind of "director-centric" solution needed to deal effectively with serious governance or performance crises.

Access will work in practice, however, only if the right is properly structured so as to encourage change without opening the door to abuses or excessive disruption.

The following proposed access bylaw suggests how such a balance might be achieved:

Shareholder Nomination of Directors

In connection with the election of directors at the company's annual meeting, a shareholder-nominated candidate for the board of directors shall be included in the company's proxy statement and on the company's proxy card, provided that all the following conditions are satisfied:

1. The shareholder or group of shareholders sponsoring the candidate (the sponsor) shall (i) own at least [three percent] of the company's outstanding shares of common stock, (ii) shall have maintained this level of ownership for no less than [two years] and (iii) shall agree to maintain this level of ownership through the annual meeting. In a case where two or more sponsors nominate different candidates, the sponsor representing the largest ownership position will prevail.

2. The sponsor shall submit the nomination and supporting documents no later than [six months] prior to the anniversary of the previous year's annual meeting, or in accordance with the company's advance notice requirements.

3. No more than [one] shareholder-nominated candidate may be included on the company proxy in a given year.

4. No shareholder-nominated candidate may be submitted if a shareholder-nominated candidate was elected to the board in the previous year and is currently a member of the company's board of directors. [No shareholder-nominated candidate may be submitted if the number of shareholder-nominated members of the board of directors would exceed the following limits: 25 percent of the board when the size of the board is 10 or fewer directors or 20 percent when the size of the board is greater than 10 directors.]

5. The shareholder-nominated candidate shall be "independent" with respect to both the company and the sponsor, using the definition of independence set forth in the company's corporate governance policies and in the listing standards of the New York Stock Exchange.

6. The sponsor shall submit a statement of no more than 500 words in support of the shareholder-nominated candidate for inclusion in the company's proxy statement. The 500-word limit shall not apply to biographical information and other disclosures about the candidate and the sponsor required by this provision or by regulation.

7. The sponsor shall file the disclosures and provide background information about the sponsor as required under SEC Rule 14a-12, and shall affirmatively state and make appropriate SEC filings indicating that it has no intention to seek control of the company.

8. The sponsor shall not seek reimbursement from the company for any solicitation expenses. [However, if the company engages in a solicitation in opposition to the shareholder-nominated candidate, the sponsor will be entitled to reimbursement for its expenses incurred in conducting a comparable solicitation.]

9. If the company currently requires a majority vote to elect directors, the majority vote requirement

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will be maintained if (i) the size of the board is expanded to accommodate the shareholder-nominated candidate, or (ii) the company agrees to replace one of the company's nominees with the shareholder-nominated candidate, thereby resulting in an election where the number of candidates for election does not exceed the number of seats to be filled. A plurality vote will be required if the inclusion of the shareholder-nominated candidate results in more candidates for election than seats to be filled.

10. The sponsor shall agree to meet with the nominating committee of the company's board of directors for the purpose of discussing the reasons for the submission of the shareholder-nominated candidate, the candidate's qualifications and independence, and any other matters relating to the nomination and election of directors. Such a meeting shall be convened by the company no later than 60 days following the sponsor's submission of the nomination.

Analysis of the Proposed Shareholder Access Bylaw

Like SEC Rule 14a-11, this proposed access bylaw is detailed and prescriptive. By its terms, access would be subject to the following limitations:

- The access right would be available only to substantial long-term shareholders;
- The right would be exercisable only at the annual meeting;
- The number of shareholder-nominated candidates and board members would be limited;
- Special-interest, non-independent candidates would not be eligible;
- Notice and full disclosure would be required;
- Reimbursement of costs would be prohibited or subject to limits;
- Dialogue between the board and the sponsor would be mandated.

From the viewpoint of long-term investors, paragraph 10 is arguably the most important provision of the proposed bylaw. The requirement for a meeting between the sponsor and the board's nominating committee is intended to promote the traditional engagement goals of dialogue, negotiation and board-sponsored change. This requirement reflects sensitivity to the importance of board collegiality. Mandated dialogue could lead to a variety of negotiated outcomes. Paragraph 9 suggests a few: selecting a compromise candidate acceptable to both sides; adding a new board seat rather than sacrificing an incumbent director; seating a well-qualified candidate as a replacement for an underperforming director. All these outcomes fall short of the feared "mini proxy contest" that many critics assume would result from access.

The independence requirement in paragraph 5 is intended to eliminate special-interest directors. It reinforces the important principle that all directors, including those sponsored by shareholders, should represent the interests of the corporation as a whole.

The access right's level of aggressiveness could be varied by modifying or eliminating some of the proposed terms, particularly those set forth in brackets in paragraphs 1, 2, 3, 4 and 8. Some shareholder activists have suggested an approach (not taken in this proposed bylaw) in which access would be accompanied by the right to call a special meeting.

Unlike Rule 14a-11, this proposed access bylaw would not be activated by pre-established "triggers." Access should not be viewed as a form of punishment inflicted only when companies have transgressed in specific ways. Shareholders should have broad discretion to decide if and when access is the appropriate method to deal with an underperforming or poorly governed company.

Other questions—many of them central to the ongoing debate over shareholder rights and governance reform—would have to be analyzed in the context of access:

- Could the sponsor's qualifying ownership position be hedged or based on derivatives that might give rise to "empty voting"?
- What would be the impact, if any, on a shareholder-nominated "access" candidate if a third party unaffiliated with the sponsor were to wage an independent election contest?

- Under state law, could shareholders create or modify an access right by unilaterally submitting a binding bylaw amendment without board approval?

- If the federal courts or the SEC were to reopen Rule 14a-8 to access proposals, what would be the impact of multiple access models?

The goal of access is not to enable a proxy contest at every annual meeting. With the exception of a small coterie of committed activists, institutional investors generally agree that conflict resolution is preferable to conflict. They would rather find constructive solutions to the problems of underperforming portfolio companies than pick fights with boards and managers. From their perspective, access should be viewed as an extension of their active engagement programs. It would provide the means to send a strong message of concern and bring a new voice into the boardroom, thereby encouraging internal changes that would improve the behavior, policies and performance of troubled companies.

Majority of Votes Withheld: Shareholders Say "No," Boards Say "Yes"

By Annalisa Barrett and Beth Young

The issue of voting on uncontested director elections—those in which no dissident candidates are running against the management nominees—has captured a great deal of attention over the past several years. This momentum has continued into the 2008 proxy season, as evidenced by the volume of shareholder proposals asking companies to shift from a plurality to majority standard in uncontested elections, the number of companies making such changes and the pressure on the New York Stock Exchange to eliminate the practice of brokers voting uninstructed shares in uncontested elections.

In a recently-published study, *The Corporate Library* found that most directors from whom majority support has been withheld are still serving on the board. The study examined the circumstances surrounding the 28 directors serving on boards of 22 US companies who did not garner majority support for their election at annual meetings held in 2006 and 2007[1]. In the vast majority of these cases, the directors were re-nominated and are still serving despite their lackluster support from shareholders.

Although it is not possible to determine the specific reasons for the withheld votes in each case, possible reasons can be inferred based on the specific circumstances for each company and director. Attendance problems and independence issues were associated with the largest number of majority withhold votes. Additionally, concerns over stock option backdating appeared to play a role.

Types of Voting Standards

In 2004, activist shareholders led by funds affiliated with the United Brotherhood of Carpenters and Joiners submitted the first proposals asking companies to move from a plurality voting standard for uncontested director elections—meaning that whichever candidate receives the most votes wins—to a majority standard in which a nominee must receive support from holders of a majority of shares. Since then, the issue has taken off, with large numbers of proposals submitted each year since (89 in 2005 and 140 in 2006 and 2007)[2].

In response to this initiative, a substantial number of companies, especially large-capitalization companies, have adopted some form of majority voting in director elections. According to a study conducted by Claudia Allen of Neal, Gerber and Eisenberg LLP, 66 percent of companies in the S&P 500 had adopted some form of majority voting, whether a true majority legal standard for election (44 percent of the S&P 500) or a director resignation policy working in combination with a plurality vote standard (22 percent of S&P 500).[3]

However, the number of failed elections remains quite modest because majority voting has not reached the companies where it would make a difference. Only three of the 22 companies identified in our recent study where a director failed to receive majority support have implemented any form of majority voting for director elections: Gen-Probe, Synopsys and Terex.

Reasons for Withhold Votes

It is not possible to know with certainty the reasons why shareholders withheld votes from the directors identified in our recent study. However, a few patterns emerge from the data. Specifically, many of the directors who were not supported by holders of a majority of shares at 2006 and 2007 meetings had attended so few meetings of their respective boards during the prior year that this lack of attendance was required to be disclosed in the company's proxy statements.[4] In addition, some of the directors identified in the study have a relationship with the company other than their service as a director, which shareholders may have viewed as jeopardizing their independence. Also, there are a few instances of companies implicated in the stock options backdating scandals where directors were targeted.

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The Corporate Library has identified ten directors from whom a majority of votes were withheld at annual meetings during 2006 and 18 directors from whom a majority of votes were withheld at annual meetings during 2007. The tables below set forth companies where one or more directors failed to obtain support from a majority of shares in 2006, as well as each director's name and the voting results (votes withheld/votes cast).

Poor Attendance

Many of the proxy advisory firms recommend a vote against a director who had attended fewer than 75 percent of the board and committee meetings during the previous year. In fact, it appears that the most common reason for directors to have votes withheld during the 2006 and 2007 proxy seasons was poor attendance at board and committee meetings. The following are a few examples of withhold votes, most likely due to a record of poor attendance:

- At Gen-Probe's annual shareholders meeting held on May 31, 2007, 70.2 percent of votes were cast against director Mae C. Jemison, M.D.'s reelection to the board. According to the Gen-Probe proxy statement, Dr. Jemison was the only director up for reelection at the 2007 meeting who had failed the board's attendance standards during 2006.
  - —In February 2007, three months before the meeting at which Dr. Jemison failed to garner majority support, Gen-Probe adopted a true majority vote standard for director elections.
  - —The company issued a Form 8-K, under Item 8.01 "Other Events" on July 19, 2007, which described the events that followed Dr. Jemison's failed election:
    - At the annual meeting of stockholders of Gen-Probe Incorporated (the Company), held on May 31, 2007, Mae C. Jemison, M.D., failed to receive sufficient votes to be re-elected to the Company's Board of Directors. The Company believes that the vote was substantially the result of a May 18, 2007 "against" recommendation on Dr. Jemison's re-election by Institutional Shareholder Services (ISS) based on "poor attendance." On May 31, 2007, immediately following the annual meeting, Dr. Jemison tendered her resignation in accordance with the Company's bylaws. Dr. Jemison has continued to serve as a director pending

Table 1: Withhold Votes in the 2006 Proxy Season

2006				
Company	*Market Capitalization Category*	*Director Name*	*Percent of Votes Withheld*	*Still on Board?**
Aeropostale, Inc.	Mid Cap	John D. Howard	51.1%	Yes
Bucyrus Int'l Inc.	Large Cap	Robert L. Purdum	60.2%	Yes
Cablevision Systems Corp.	Large Cap	Charles D. Ferris	50.2%	Yes
Hologic, Inc.	Large Cap	Jay A. Stein	50.4%	Yes
Hologic, Inc.	Large Cap	Glenn P. Muir	54.3%	Yes
Hologic, Inc.	Large Cap	Lawrence M. Levy	63.7%	Yes
Progress Software	Mid Cap	Scott A. McGregor	58.9%	Yes
Synopsys, Inc.	Large Cap	A. Richard Newton	63.3%	No
Terex Corp.	Large Cap	Julius Caesar (J.C.) Watts r.	60.9%	No
TETRA Technologies, Inc.	Mid Cap	Allen T. McInnes	51.3%	Yes

**As of original publication date—April 8, 2008.*
Source: The Corporate Library

Table 2: Withhold Votes in the 2007 Proxy Season

2007				
Company	*Market Capitalization Category*	*Director Name*	*Percent of Votes Withheld*	*Still on Board?**
Activision	Large Cap	Barbara S. Isgur	62.7%	Yes
Activision	Large Cap	Robert J. Morgado	63.1%	Yes
Activision	Large Cap	Peter J. Nolan	59.6%	Yes
Analogic Corp.	Mid Cap	Bernard M. Gordon	50.8%	Yes
Analogic Corp.	Mid Cap	John A. Tarello	59.9%	Yes
Gen-Probe	Large Cap	Mae C. Jemison	70.8%	No
Guitar Center	NA	Bob L. Martin	50.3%	NA
Men's Wearhouse, Inc.	Mid Cap	Deepak Chopra	51.2%	Yes
Newfield Exploration Co.	Large Cap	Juanita F. Romans	52.7%	Yes
Penn Virginia Corp.	Mid Cap	Gary K. Wright	50.2%	Yes
Polycom, Inc.	Mid Cap	John Seely Brown	67.8%	No
Quiksilver, Inc.	Mid Cap	Laurent Boix-Vives	52.2%	No
Semtech Corp.	Mid Cap	James P. Burra	60.2%	Yes
Semtech Corp.	Mid Cap	Rockell N. Hankin	60.0%	Yes
Semtech Corp.	Mid Cap	James T. Schraith	64.0%	Yes
Starwood Hotels & Resorts Worldwide, Inc.	Large Cap	Jean-Marc Chapus	61.3%	Yes
Tessera Technologies, Inc.	Mid Cap	John B. Goodrich	66.0%	Yes
Wabash National Corp.	Small Cap	Ronald L. Stewart	57.9%	Yes

**As of original publication date—April 8, 2008.*
Source: The Corporate Library

a decision of the Board of Directors to accept or decline her resignation, pursuant to Delaware law.

—The company reported that Jemison's resignation was "reviewed and considered" by the board's nominating and corporate governance committee. The committee concluded that Dr. Jemison's attendance problems were only an issue during the year in question and would not be a concern in the future, and they recommended that the board not accept Dr. Jemison's resignation. "At a telephonic meeting held on July 17, 2007 … the Board accepted the recommendation of the Committee and by a 5-0 vote adopted a resolution declining to accept Dr. Jemison's resignation."

—After all of this, Dr. Jemison resigned from the board—with no specific explanation provided – on November 14, 2007.

- Shareholders of Terex Corporation withheld 60.9 percent of votes from Julius Caesar (J.C.) Watts, Jr., a former US Congressman from Oklahoma, at the annual meeting for equipment manufacturer Terex Corporation held on May 31, 2006.

—Mr. Watts was the only Terex Corporation director who did not meet the board's attendance standards as disclosed in the company's proxy statement.
—According to Claudia Allen's study of voting policies, Terex adopted a majority vote policy as of December 13, 2006 in connection with a settlement of stockholder derivative litigation. Although this policy was adopted after shareholders withheld support from Watts, it may well have led to his departure from the Board.
  • On February 23, 2007, Mr. Watts notified the Company that he was not going to stand for re-election as a director of the Company.
  • He served the remainder of his term, which expired on May 17, 2007, the date of the company's 2007 annual meeting of stockholders.

- One director at retailer Aeropostale, Inc., John D. Howard, saw a majority of votes (51.1 percent) withheld from his candidacy for director at its June 14, 2006 annual shareholder meeting.
  —Mr. Howard was the only Aeropostale director who did not meet the board's attendance standards during the 2005 fiscal year, which ended January 28, 2006. Mr. Howard attended only four of the six full board meetings during 2005 (he did not serve on any board committees).
  —The company made no disclosure indicating that Mr. Howard, or any other members of the Aeropostale board, failed the board's attendance standards during the 2006 fiscal year. Less than 1 percent of shares voted at the 2007 annual meeting withheld support from Mr. Howard.

Independence Concerns

A few of the directors who failed to garner majority support at 2006 and 2007 meetings may not be considered independent directors by some shareholders. For example:

- Director Robert L. Purdum did not obtain support from 60.2 percent of shares voted for his reelection to the Bucyrus International Inc. board at the company's annual shareholder meeting held May 3, 2006. Mr. Purdum was 70 years old at the time of the election. He is a partner of American Industrial Partners, a private equity firm, which was the controlling stockholder of Bucyrus until November 2004. He served as the Non-Executive Chairman of the Bucyrus board from 1997 to 2004. Mr. Purdum continues to serve on the Bucyrus board.

- One director at TETRA Technologies, Allen T. McInnes, failed to garner majority support at the annual shareholders meeting on May 2, 2006. Holders of 51.3 percent of shares withheld their support from Mr. McInnes. Mr. McInnes was President and CEO of TETRA from 1996 to 2000. He continues to serve on the TETRA board and on both the audit and nominating and corporate governance committees. At TETRA's 2007 annual meeting, 37 percent of the votes cast were withheld from Mr. McInnes's reelection.

Attendance Problems and Independence Concerns

A few directors identified in the study may have lost support of shareholders due to attendance problems and independence concerns. For example:

- Holders of 61.3 percent of shares voted withheld support from Director Jean-Marc Chapus at the Starwood Hotels & Resorts annual shareholders meeting held on May 24, 2007.
  —Starwood was the only S&P 500 company at which a director failed to receive support from a majority of the votes cast at a meeting during the 2007 proxy season.
  —Mr. Chapus is the Group Managing Director and Portfolio Manager of Trust Company of the West, an investment management firm, and President of TCW/Crescent Mezzanine LLC, a private investment fund. He is the chairman of the compensation committee of the Starwood board and he was the only Starwood director who failed the board's attendance standards, as reported in the company's proxy statement.
  —Additionally, independence may have been a concern, based on the following relationship described in the company's 2007 proxy statement:
    • In addition, in the case of Mr. Chapus, the Board considered a transaction with Raintree Resorts International, the owner of the Club Regina Resorts in Mexico, pursuant to which the Company, among other things, purchased real assets and settled certain litigation.

Certain funds of TCW/Crescent Mezzanine LLC that are not managed or controlled by Mr. Chapus received some of the proceeds from such transaction in exchange for an option for Starwood to acquire certain bonds issued by Raintree Resorts International held by such funds. The Company owns a majority of the outstanding bonds issued by Raintree Resorts International. The total amount paid by the Company to these funds was $10,000,000. The Company believes that its agreement was negotiated at arms-length. Mr. Chapus has informed the Company that he did not derive any personal benefit from this agreement, although his compensation does depend, in part, on TCW's results of operations.

— Mr. Chapus still serves on the Starwood board.

Backdating Stock Options

A few of the boards which had several directors receive a majority of votes withheld were subject to scrutiny regarding the backdating of stock options. In the example below, the members of the Compensation Committee were targeted by shareholders:

- Holders of a majority of votes cast withheld their support from three directors on the Activision board at the company's annual shareholder meeting held on September 27, 2007: Barbara S. Isgur (62.7 percent withheld), Robert J. Morgado (63.1 percent withheld) and Peter J. Nolan (59.6 percent withheld).
  — The company is currently under investigation for the backdating of stock options by the SEC and the subject of related securities litigation.
  — Each of these directors served as members of the board's Compensation Committee.
  — All three directors continue to serve on the Activision board and on the compensation committee.

Conclusion

It is clear that boards often do not listen to the message sent by shareholders who withhold votes for director candidates. Of the directors examined, the vast majority are still serving on the boards of the companies—against the wishes of a majority of shareholders. It may be the case that more widespread adoption of majority voting standards or policies will change these patterns. We will be watching the results from the 2008 proxy season to see if boards begin to pay more attention to the wishes of shareholders.

Notes

1. The complete report is available to subscribers of The Corporate Library's Board Analyst database or for purchase separately at www.thecorporatelibrary.com.

2. 2005 and 2006 numbers are from "Majority Voting in Director Elections: A Look Back and a Look Ahead" ST&B Aug. 4, 2006, at *http://www.simpsonthacher.com/content/publications/pub560.pdf*; 2007 numbers are from Anne Moore Odell, "Executives and the Environment: Looking Back at Proxy Season 2007," Sustainability Investment News, July 27, 2007, at *http://www.socialfunds.com/news/article.cgi/article2337.html.*

3. *Study of Majority Voting in Director Elections*, by Claudia H. Allen of Neal, Gerber & Eisenberg LLP, Last Updated: November 12, 2007.

4. Item 7(f) of Schedule 14A requires companies to disclose whether any directors attended fewer than 75% of the board meetings (and board committee meetings on which the director serves) held during the past fiscal year in the proxy statement.

Best Practices for Corporate Minutes

By Elizabeth C. Hinck

Claims against directors have shown the crucial role corporate minutes can play in determining whether directors met their fiduciary obligations. Good minutes reflecting a sound deliberative process can help a court dismiss a lawsuit alleging breach. Poor minute keeping can result in protracted litigation to determine the care that went into a board's decision to act.

For example, in shareholder litigation over the proposed sale of Netsmart Technologies to a private equity buyer, the Delaware Court of Chancery viewed the absence of minutes supporting key aspects of the board's decision-making process to be a critical problem when evaluating their actions. Vice Chancellor Strine chided the board, noting that its minutes practices were, "to state the obvious, not confidence-inspiring."

Also, given that activist shareholders may gain access to board minutes under most state corporation codes, companies should take care to keep an accurate, precise and complete record of director decision making and oversight. When the minutes of meetings come under the microscope, directors will want to know these records reflect the care, consideration and hard work that went into their actions.

Despite the clear and convincing benefits of good minutes, then, why does the record of so many board and committee meetings fall short? The answer may lie in the lack of a clear understanding by boards and their corporate secretaries of some fundamental best practices. Consider these suggestions for keeping good corporate minutes.

Be Complete and Precise About Actions and Deliberations

Most simply, minutes are the best record of actions and deliberations of a board or committee. Courts and regulators frequently look to minutes as the most reliable source for evaluating what directors did or did not do. For example, in *Netsmart*, the court considered the minutes to be a better record than a description in a proxy statement or a director's testimony.

Minutes need to reflect the basics, such as compliance with procedural requirements, identification of the directors present, the matters considered and the actions taken or approved, as well as other decisions reached. A checklist of some of the basic elements that should be identified for each meeting is provided below under "Be Prepared."

Ensuring that minutes are complete and precise in describing each action taken and the scope of approval or authorization can provide clarity in the short-term (such as determining which officers are authorized to sign a loan agreement at closing) and down the road (such as when searching for specific authorization of all stock issuances in pre-IPO due diligence).

Take Care to Show Care

High-profile shareholder litigation, from *Smith v. Van Gorkom*,to the *Walt Disney Co. Derivative Litigation*, reveals that minutes matter when evaluating whether director fiduciary duties have been met in making specific business decisions. The minutes of Disney's board and compensation committee were primary evidence not only of the actions taken on Disney executive Michael Ovitz's employment package, but also of the quality of the deliberative process: what documents were reviewed, what questions were asked, what expert reports were heard, what information was disclosed and how much time was spent? Although the Delaware court found that the Disney directors were not liable for breach of fiduciary duty for their actions, the board minutes offered little help to the defendants and failed to prevent a lengthy and costly trial.

Minutes also may reflect the extent to which a board or committee exercised diligent oversight. The court in *In re Caremark International Inc. Derivative Litigation*, noted the significance of a

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record showing active and informed consideration by the Caremark directors when concluding that the directors satisfied their duty of care, despite their failure to detect wrongdoing.

Active, attentive, informed and independent-minded service remains at the core of fiduciary requirements. Minutes cannot reflect these crucial behaviors where they do not occur. But when directors act in good faith, with care and loyalty, the minutes should be written carefully to demonstrate that fact.

Reflect the Deliberative Process with Appropriate Details

In order to best reflect a careful deliberative process, consider these examples:

Scope of discussion. Capture the substance of inquiry and response without taking a "who said what" approach. For example, the minutes could reflect that "members of the audit committee then asked specific questions, and the CFO responded in detail, concerning the assumptions and estimates made in preparing the financial statements."

Time devoted to discussion. Consider showing the real time devoted to agenda items in the minutes. At trial before the Delaware Chancery Court, the plaintiffs in the *Disney* case pointed out that important items were referred to cursorily in the minutes, implying that little time was spent on those items. Consider saying things like, "the board then discussed this matter at length" or even referring to the amount of time spent, to overcome this problem.

Information and documents presented and considered. Time devoted to a topic or depth of discussion may not be the key to understanding the board's care. Sometimes, it is the quality of the information provided and presented to the board that makes detailed discussion and Q&A unnecessary. In these circumstances, the full meeting record should be clear as to information and material presented to the board and if documents were provided for advance consideration. Make sure the record reflects that directors had an adequate opportunity to review key documents before acting on them.

Incorporation by reference. If possible, be specific as to any documents considered by the board or committee, referring to the title and the date, without attaching the documents into the minute book itself. The company should maintain a complete but usually separate file of supporting documentation. Keeping a clear record (in the minutes or otherwise) of the documents delivered, as well as the timing of delivery, can be instrumental in showing that the directors were fully informed. In addition, where a knowledgeable expert further explains documents such as key employment or transaction agreements, the minutes should be clear on this fact. If significant discussions or actions preceded a meeting but formed an essential part of the ultimate actions taken or decisions made, consider making an appropriate reference to these in the minutes.

Reliance on advisors. Reflect participation by advisors (legal, financial, accounting, tax, compensation consultants or other professionals) and whether the board or committee relied upon the advisor's report, advice or opinion.

Do not Delay or Short-Cut Review

Minutes should be drafted and circulated to directors as soon as possible after the meeting itself. In *Netsmart*, the fact that minutes were not prepared until shareholder litigation had been commenced, and then were prepared all at once, seriously undermined the Delaware court's confidence in the record.

Prompt consideration of the minutes by directors and other participants will ensure that the meeting remains fresh in everyone's mind and will minimize potential uncertainty over what occurred. Explain to directors regularly how essential careful review of draft minutes is to their fiduciary obligations and to avoiding liability. Review of minutes by directors must not be a last-minute, perfunctory process.

Be Prepared

It is nearly impossible for a meeting secretary to keep a good record of board or committee proceedings without plenty of advance preparation. Proposed resolutions for anticipated actions should be drafted and circulated to the board or committee before the meeting. In addition, the secretary can be considerably more effective when using a checklist or template to record key information, such as:

- Date and location
- Whether the meeting is a regular, organizational or special meeting
- Whether the meeting is held by telephone conference call or in person
- Beginning and ending time
- Names of attendees and those absent
- Acting chairman and secretary
- Names of presenters or other participants
- Headings indicating general topic under discussion (which may be taken from the agenda)
- Indication of action taken (action terms to consider: discussed, agreed, approved, authorized, deferred, noted receipt of)
- Comings and goings of members or participants
- Resolutions adopted
- References to briefing materials disseminated in advance or material discussed or presented at the meeting by specific date and title.

Give Committee and Subsidiary Minutes Due Attention

The *Disney* and *Netsmart* cases both demonstrated clearly that committee minutes are just as important as full board minutes. Minutes of major board committees (such as audit, compensation, governance, nominating or other special independent committees) must be given as much care and attention as those of the full board.

Increasingly, directors are asking to see the minutes of committees on which they do not serve, due to the significant role these committees undertake on behalf of the board. Routinely providing minutes of audit, compensation and governance committees to all directors is a best practice, allowing the full board to understand and evaluate the activity, deliberations and performance of these critical committees.

Compensation committees should be especially careful to document in the minutes the steps taken to properly inform themselves when fixing the compensation of senior executives. For example, make specific reference to reports or presentations of compensation committee consultants, review of "tally sheets" setting forth all the elements of an executive's compensation or explanations by experts of change in control provisions in employment agreements.

Governance reforms since the Sarbanes-Oxley Act of 2002 also have imposed more specific duties on the audit committees of public companies. These rules affect the content of the minutes of audit committees. In particular, audit committee minutes should demonstrate that the audit committee addressed each of the responsibilities required under its charter, as well as an annual review of the charter itself. While no one recommends that audit committees take a "check the box" approach to their duties, these committees should have a clear meeting checklist to assess key items covered so that the minutes can accurately reflect this fact. Audit committee minutes of US public companies are becoming increasingly detailed to reflect the significant oversight role these committees perform.

Board minutes of subsidiaries should also be given careful consideration in many cases. Even where subsidiaries are wholly-owned, cutting corners or being less than punctilious in memorializing actions and deliberations can have disastrous results.

Seek Clarification When Needed

In order to be accurate, the meeting secretary may need to seek clarification of points of discussion or action during the meeting itself. While a corporate secretary may be reluctant to interrupt the discussion, it is in the best interest of all concerned that they do so if there is a question as to what has been decided or approved. In many cases, if the secretary is not sure, at least some of the directors are unsure also.

Write Well and Edit

Principles of good drafting applicable to contracts or other legal writing also apply to drafting minutes. Use concise, unambiguous language to avoid having a court look to other sources for

clarification, explanation or definition. Take care to ensure that the minutes are accurate and complete, consistent in language and approach and free from unnecessary information or potential traps. Carefully review and edit the minutes to eradicate stupid mistakes (such as indicating the presence of an absent director or vice versa) that call the entire record into question.

Strive to use language that is as neutral as possible, and stay away from adjectives or adverbs reflecting your own value judgments. Avoid confusion by using "standard English" (all words used in their ordinary and normal sense).

Set Clear Document Retention Policies

Companies should set clear document retention policies for meeting notes, board packages and related documents, and directors should be fully informed (and periodically reminded) of these policies. Notes of individual directors or other meeting attendees should not survive once final minutes have been approved. The best practice for many companies is either to have only the meeting secretary keep notes or to collect and destroy the notes of meeting participants at the end of the meeting. Once the minutes have been reviewed and approved by the board or committee, all drafts and notes of the meeting secretary should be destroyed, as well. Generally, the final minutes (as kept in the official minute book), together with a clean copy of the official board package and any other materials specifically referred to in the minutes, should be the only permanent record maintained by the company.

Don't Record Meetings or Transcribe "Who Said What"

Minutes should summarize, rather than transcribe verbatim, what occurred at a board or committee meeting. Minutes generally should not reflect who said what, and, instead, should more generically refer to discussion between directors and other participants in the meeting. Audio or video taping a meeting is a particularly bad idea. The presence of recording equipment may have the tendency to chill a healthy exchange of information. In addition, comments made in the ordinary give-and-take of a board meeting may prove embarrassing or harmful later when taken out of context.

Build Board Meetings into Disclosure Controls and Procedures

US public companies are required to report on SEC Form 8-K within four business days specific events, including entry into material agreements (such as M&A agreements), new and amended executive compensation arrangements and conclusions about asset impairments, restatements and restructurings. Board or committee action with respect to these matters may trigger the four-day period. As a result, minutes must be drafted to distinguish between discussions about possible actions and the approval of the action itself. In addition, the lesson of the SEC's 1992 enforcement action against Caterpillar is that minutes need to be carefully considered in the context of securities filings, particularly in connection with MD&A disclosure. The Caterpillar decision noted discrepancies between the company's board minutes—which showed that the board was apprised of a volatile situation involving a major foreign subsidiary—and its MD&A disclosure—which was silent on the subject.

Special Situations

Conflicts of interest. A director has a duty to put the interests of the corporation above his or her own in all matters relating to the corporation. In a transaction involving a conflict between the director's personal interests and those of the corporation, the duty of loyalty requires the director to act in a manner that is "entirely fair" to the corporation. If the conflict-of-interest transaction has been approved, after full disclosure, by a disinterested decision-making body (such as the disinterested directors or shareholders), Delaware courts have held that the burden of proof shifts. Instead of the director in question having to prove that the transaction or taking was fair, the challenging party must prove that it was *not* fair. For this reason, minutes reflecting approval of a conflict-of-interest transaction must be drafted with special care and attention to memorialize formal details—such as the conflicted director's recusal from discussion and abstention from voting on the matter—observed in the process.

Privileged discussions. Meeting discussions with legal counsel may be privileged. The details of these discussions should not be memorialized in the minutes due to the fact that minutes are readily shared with third parties. Rather, the minutes should indicate that the board or committee participated in a privileged discussion with counsel, with only the most general reference to the subject matter of the discussion.

Executive sessions. The NYSE requires non-management directors to meet in regularly scheduled executive session in which management is not present. Executive sessions are intended to serve as a vital "safety valve" for open dialogue among independent directors. Keeping complete minutes of these discussions is unnecessary and inconsistent with their purpose. However, a record should be kept that an executive session was held, who attended it and when, where and how long the meeting was held. The chair of these sessions should also report to the company's secretary if any actions were approved as well as a brief list of items discussed.

Informal discussions. In *Netsmart*, a critical decision was made at a meeting later dubbed "informal" (as no minutes were prepared). Significant discussions and decisions should occur at formal meetings and recorded in the minutes. If important conversations among directors, or between directors and their advisors, occur outside of a formal meeting, however, consider whether these discussions can be referred to in the minutes in a manner that provides an appropriate understanding of the directors' actions or decisions at the meeting.

Conclusion

Excellence in keeping corporate minutes not only ensures that an accurate record of corporate actions exists, it actually improves corporate governance and helps ensure that governance is linked to disclosure controls and procedures. The process of producing an accurate, precise and complete record of director decision-making and oversight imposes a discipline on the process that drives better preparation, engagement and careful consideration every step of the way.

Keeping corporate minutes is far more than a ministerial function. It is essential that the function be overseen and guided by someone with the experience, education and position to appreciate best practices and the extent to which excellence in corporate minutes can foster excellence in corporate governance.

Notes

1. *See In re Netsmart Technologies, Inc. Shareholder Litigation*, 924 A.2d 171 (Del. Ch. 2007). In *Netsmart*, proving adequacy of the deliberative process was made difficult by poor minute keeping. The meeting at which the directors claimed to have actually decided to sell was "informal" and never memorialized in minutes. And, minutes for the 10 meetings at which directors formally considered the transaction over a period of four months were not approved until after shareholders filed litigation.

2. *Id.* at 191.

3. *See, e.g.*, Del. C. § 220. For a discussion of shareholders' rights to inspect corporate records, *see* Hinck, "Open season for board minutes," *Directors & Boards*, (Second Quarter 2006).

4. *See* 924 A. 2d at 187. In *Netsmart*, no minutes existed for special committee deliberations that were described in the company's proxy statement. The court noted, "as such, one cannot determine who was present at this meeting or what specifically was said or done."

5. 488 A.2d 858 (Del. 1985).

6. 825 A.2d 275 (Del. Ch. 2003).

7. 698 A. 2d 959 (Del. Ch. 1996).

8. In his article "Legal Usage in Drafting Corporate Resolutions," *The Practical Lawyer* (Sept. 2002), Ken Adams gives numerous suggestions and examples for removing legalisms and archaic terms to enhance the clarity of corporate actions.

9. SEC Rel. No. 34-30532 (Mar. 31, 1992).

Rethinking Stock Ownership Guidelines

By Betsy Atkins

New governance recommendations and pronouncements come from different sources regularly with the purpose of attempting to improve oversight of public companies for shareholders. Many of the recommendations do not work when implemented or have significant unintended negative consequences. One good example is the Sarbanes-Oxley Act of 2002, which has had the unintended consequences of mandated large, unanticipated costs for all companies, especially hurting small and medium sized companies and their shareholders—by reducing profits and making them less competitive. Also, after SOX was passed, an amazing unintended consequence occurred for the US financial markets in 2005: Twenty four out of twenty five of that year's largest IPOs went to international markets, a total reversal of the prior year's outcome.

Institutional Shareholder Services, now a division of RiskMetrics Group, holds itself up as a source of wisdom with its ISS CGQ scoring of about 70 items to rate a company's governance oversight. This scoring has driven public companies to make politically correct or poor decisions to increase their score. Good governance ideas come in and out of vogue, such as, should the CEO and Chairman position be separated or combined? Separation of the roles is the recent trend. Currently, because of ISS, one politically correct idea is the idea of mandating that company executives and directors own and retain equity in their companies.

The adoption of mandatory stock ownership policies is a trend that is now accelerating. This concept that executives must own or hold equity they have earned is inherently immoral, as well as being plainly ineffective for shareholders. Mandating an executive not to "cash their check" on earned income, of which equity is a part, is unfair. This mandate of ownership was not in most executive's original employment contract. So-called ownership "guidelines" are in fact mandates that are involuntary and an undesirable change in executive compensation plans.

Every worker, including executives, prefers freedom to sell their equity and invest or spend whenever and wherever they desire. "Financial Planning 101" tells us to diversify. However, companies now are mandating that a huge amount of an individual's worth be held in one asset, thereby not permitting the executive the choice of diversifying his or her assets. I still remember the sobbing Enron employees testifying before Congress how they could not sell their earned shares and just watched as their nest egg disappeared. Do the company's shareholders then owe an obligation to reimburse the executives if the company's stock declines and their equity greatly diminishes? Stock equity is inherently volatile and prudence dictates lowering concentrations and diversifying.

Another purported benefit of mandating equity ownership is that the executive will "think like an owner." It is supposed by the supporters of ownership mandates that this ownership mentality will drive executive behavior and decisions to align the executives with the shareholders. You hire the executive to be an executive. You do not contract them to be an "owner." If the executives want to be owners, they should be free to hold or buy equity. Under ownership mandates, executives—in most cases—end up with an enormous proportion of their personal wealth concentrated in one company.

Will the mandates have the desired effect on the executive to make the "best" decisions? Or will it have the unintended consequences of driving them to leave the company in order to cash out? Could an executive under-invest in long-term research & development? This would drive short term profits so that the stock is highest at their retirement; the only time when they can sell? Were the executives of Enron and WorldCom, who couldn't sell their equity, motivated by this "ownership mentality"?

Mandating ownership is an imprudent and unfair governance idea that has come into fashion and does nothing to achieve alignment between executives and shareholders.

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More importantly, mandating equity ownership does nothing to attract or retain top talent. This is further overregulation of corporations, thus making the competition to attract and retain executive talent harder, and in the long run, hurting the shareholders. Equity mandates blur roles and responsibilities. Executives are employees responsible to build and lead profitable enterprises on behalf of shareholders, who are the owners. Executives should be able to cash out their earned compensation packages. To control buying and selling stock is a socialistic attack on freedom and free markets.

A Guide for Avoiding Liability: Understanding Key SEC Enforcement Policies and Priorities

By Thomas O. Gorman and William McGrath

Despite calls for reform from Congress, a SEC Commissioner, various business groups and others, and pressure from the current market crisis, the SEC's Enforcement Division continues its traditional approach of, at times, acting like a "cop on the beat," pursuing whatever catches its attention, at other times, acting like a cold-case detective focused on conduct that took place years ago, and, at still other times, acting like a criminal prosecutor by regulating through litigation. These multiple roles sometimes cause the Commission to push the edges of the law, focus on bygone conduct that is of little interest to forward-looking markets, and create shifting standards through piecemeal litigation. Understanding these multiple roles is critical to avoiding or, at the very least, minimizing liability.

An Aggressive, Sometimes Effective, Program with Troubling Courtroom Losses

A review of 2007 enforcement statistics, at first glance, paints a picture of a vibrant, effective program. The number of cases brought by the SEC increased 10 percent over previous years—a milestone since, in earlier years, cases had decreased by about five percent annually. The SEC, moreover, prevailed in 92 percent of the actions it brought, obtaining either a settlement or a default. In 2007, the Commission obtained orders requiring the payment of $520 million in disgorgements and penalties.

A closer look, however, reveals troubling signs. The amount of disgorgement and penalties decreased by more than 50 percent, prompting Congressional calls for an inquiry. The SEC's response, which cited record payments in the first quarter of 2008 based largely on a $600 million settlement in the *McGuire/United Health* options-backdating litigation, did little to quiet concerns. Most of the money paid in that matter was in private class and derivative actions rather than the SEC action.

The ill-fated, mishandled Pequot Capital inquiry was also an area of concern. That matter resulted from a former SEC staff member's whistleblower complaint that alleged undue influence in the conduct of an insider trading investigation and resulted in Congressional criticism of the Commission's investigative processes.

Other troubling signs arose from botched court cases and judicial criticism. In *SEC v. Packetport.com, Inc.*, the SEC's investigation of an alleged raw market manipulation took so long that the statute of limitations for penalties expired before the complaint was filed.[1] Later, the complaint was dismissed for want of prosecution. This debacle ended when SEC consented to a face-saving settlement with defendants that allowed defendants to avoid an appeal. In *SEC v. Jones*, the court dismissed SEC claims for civil penalties as time-barred and refused to enter its usual statutory injunction because the conduct was so old that the remedy would be impermissibly punitive.[2] In *SEC v. Todd*, the court granted post-trial motions that, in effect, largely dismissed the case and criticized the SEC for misrepresenting key facts.[3]

A series of cases against hedge funds involving Private Investment in Public Equity (PIPE) offerings intensified concerns about enforcement. In each case where the SEC was forced to litigate, it lost claims involving the alleged sale of unregistered securities. What is more troubling, however, is that, in two of the three losses, the court criticized the legal theory argued by the SEC and, in one case, questioned the agency's candor, echoing a theme raised in *Todd.*

Insider Trading

The SEC has re-emphasized this traditional enforcement area in the wake of Congressional

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pressure and global reports of rampant misconduct. The Commission responded by bringing a series of cases involving trade based on future corporate events, such as mergers and earnings announcements. Many of these cases involved corporate directors and attorneys and, in a new series of actions, spouses and family members engaged in "pillow talk."

The *SEC v. Guttenberg* action is considered by many to be the most significant insider trading case brought in years, in part because the defendants were largely Wall Street professionals trading on information from major investment banks.[4] In this case, the SEC named 14 defendants, and, in what appears to be an increasing trend, DOJ brought criminal charges against 13 individuals. The cases are based on two trading schemes. One involved trading ahead of UBS market reports. The second alleged trading on transaction information obtained from Morgan Stanley. Each criminal defendant has pled guilty.

The SEC's aggressive enforcement posture has pushed the factual and legal edge of the envelope. Frequently, cases are based on little more than trading data and DOJ support. The News Corp./Dow Jones insider trading case, *SEC v. Wong*, is a typical example of this type of case.[5] That action, brought within days of a takeover announcement and later settled with the assistance of the Hong Kong Securities and Futures Commission, was based largely on trading data. Although the SEC successfully resolved the case, quickly filing in other similar cases carries the risk of wrongful prosecution. The lack of a full investigation and over-reliance on trading data increases the chance of ensnaring the innocent and incorrectly stigmatizing a person as a scofflaw. Many experts agree that suspicious trading alone—frequently the predicate of such actions—is insufficient to prove insider trading and may have innocent explanations.

Other enforcement positions raise significant concerns for executives. Last year, SEC Division of Enforcement Director Linda Thomsen announced that the Division would scrutinize executive trading under Rule 10b5-1 plans. That rule was crafted as a safe harbor for executives to trade without concern about insider trading. Now, however, in the wake of a business school study suggesting that there are abnormal returns under these plans (the same kind of study that touched off the options backdating scandal), the once safe harbor may no longer be safe.

Other conduct once thought immune from prosecution is now apparently under scrutiny. In *SEC v. Barclays Bank*, the SEC alleged that defendants traded bonds on inside information in six different bankruptcy cases.[6] Some of the transactions involved the use of a "big boy" letter to tell the other parties that the bank had undisclosed, material information about the deal. Many thought these letters could be used to avoid liability. Because the case settled, there is no opinion on the viability of insider trading claims involving such letters. The case, nonetheless, represents the Commission's views on the subject.

The SEC appears to be pushing the edges of insider trading liability in other areas. For instance, a requirement for insider trading liability is breach of duty. Yet, in *SEC v. Dorozhko*, the court dismissed the SEC's complaint against a defendant who obtained inside information by hacking a computer system because there was no breach of duty.[7] Although that case is on appeal, the Commission later filed a settled enforcement action, *SEC v. Stummer*, based on similar facts where there, again, was no apparent breach of duty.[8]

The Foreign Corrupt Practices Act

This area is also the subject of re-invigorated SEC and DOJ enforcement. Last year, there were 38 FCPA cases filed, compared to 15 the previous year. Ten individuals were criminally charged with FCPA violations last year, the same number who were charged during the previous three years. At the end of 2007, more than 100 FCPA investigations remained open.

A key trend in this area is industry-wide investigations. Perhaps the most significant examples stem from the U.N. Oil for Food Program (OFFP). A report on the program concluded (1) that Iraq manipulated the program to dispense contracts based on political preferences and obtain illicit payments and (2) that 2,253 companies paid over $1.8 billion in illicit income to the Iraqi government. About two dozen companies have disclosed inquiries related to OFFP. In addition, the SEC and DOJ have a number of open investigations focused on the oil side of the program, where kickbacks are frequently booked as part of the contract, and on the humanitarian side, where "after-service" fees are typically added to the deal.

Cases against individuals are also a primary focus of FCPA enforcement efforts... Both the SEC and DOJ have made it clear that, in addition to bringing actions against business organizations, they intend to focus on, and bring actions against, individuals. Last year, the SEC and DOJ brought 10 actions against individual corporate executives. This year, the first case brought against a sitting Congressman (Representative Jefferson) will go to trial.[9]

As with insider trading, the new focus on FCPA violations has been evidenced by aggressive enforcement. Last year, record penalties were imposed in FCPA cases. The record $44 million payment in the *Baker Hughes* case was paid to resolve a combined SEC/DOJ FCPA case. That case set another record with payment of $10 million as a penalty for violating a prior SEC cease-and-desist order—a point that emphasizes the importance of consent decrees and the need to carefully consider the benefits and risks of entering into such a settlement. Another record was set in *Vetco International* with the payment of $26 million, the largest payment ever to resolve a DOJ FCPA case.

Increased emphasis translates into expansive interpretations of the Act. A significant limitation on anti-bribery provisions, for example, is the requirement that payment be made to "obtain or retain business." By including this language, Congress clearly did not intend to prohibit every payment. As a result, debate about whether payments related to tax considerations were within the meaning of the anti-bribery provisions. At the government's urging, two 2007 Fifth Circuit decisions held that such tax-motivated payments are prohibited.[10]

Promotional expenses are also supposed to be exempt from the anti-bribery provisions. However, the SEC recently settled a significant case with Lucent Technologies involving such payments. In that case, the SEC concluded that 315 of about 1,000 payments made to Chinese officials in connection with product promotions contained a disproportionate amount of sightseeing, entertainment, and leisure.[11]

Financial Fraud Cases

Financial fraud likewise continues to be a staple of the Enforcement Division. Typical cases from last year included an action against Nortel Networks. In that settled enforcement action, the SEC's complaint alleged improper acceleration of revenue to meet earnings targets and improperly established reserves in 2000, 2001 and 2002. Although the company rendered what the SEC called "substantial cooperation," it also paid a $35 million penalty as part of the settlement.[12] Another financial fraud example is the action against Federal Home Loan Mortgage Corporation. There, the company paid a $50 million civil penalty based on claims that it improperly smoothed its earnings curve in 2000, 2001 and 2002.[13] The years-old conduct in these cases also illustrates the sometimes slow pace and backward look of enforcement.

The Options Backdating Scandal

The option backdating scandal, which began in the fall of 2005 with a series of academic studies, has spawned dozens of investigations and several enforcement actions by the SEC and DOJ. The lingering question is what prosecution standards will be used to resolve approximately 80 open investigations.

The earliest cases involved intentional violations of the law.[14] A case brought in December 2007 suggests that the standards may be shifting though. In *SEC v. Maxim Integrated Products, Inc*., the SEC alleged that Maxim routinely granted backdated, in-the-money options to its employees.[15] According to the SEC's complaint, Maxim's then-CEO John Gifford directed CFO Carl Jasper to properly account for backdated options. Mr. Jasper did not. Mr. Gifford settled by consenting to a statutory injunction prohibiting future violations of Section 17(a) (3)—a negligence standard—and agreeing to disgorge $652,000, which represented his portion of his bonuses, and a civil penalty of $150,000. This outcome suggests a significant change in prosecution standards.

The Subprime Crisis

The subprime crisis will be another enforcement priority in coming months. Last spring, the Enforcement Division formed a subprime task force, which is focusing on questions relating to securitization as well as disclosure and valuation issues and sales to investors. The Commission

reportedly has 36 open investigations in this area. In addition, the SEC is coordinating with banking regulators and the International Organization of Securities Commissioners (IOSCO) Subprime Task Force. A significant focus of the IOSCO as well as the SEC will be credit rating agencies and their role in this still-unfolding scandal.

Key Enforcement Concerns

Three key enforcement policies present concern for businesses: cooperation, parallel proceedings, and corporate penalties. First, cooperation credit—that is, what must be done to avoid or mitigate DOJ or SEC prosecution—has been a topic of concern in recent years. Many critics claim that the policies of DOJ and SEC have spawned a "culture of waiver," stripping organizations and individuals of key rights. Calls for reform have come from Congress, which is considering legislation, and the American Bar Association as well as others.

Although DOJ has revised some of its policies, the SEC has not and continues to follow the corporate prosecution and cooperation standards outlined in its 2001 SeaboardRelease. Under those policies, a company need not waive privilege to obtain cooperation credit. Enforcement Director Thomsen made clear in a 2007 speech, however, that the policy, as administered, is much more direct. In one example, the company was not prosecuted; in a second, the company was prosecuted. Both entities cooperated. The first waived privilege. The second did not.

The benefits to cooperation are not uniform. Self reporting, cooperating, and waiving privilege do not necessarily result in no prosecution. Compare, for example, the result of the SEC's investigation of the *Retirement System of Alabama*[16] (where the SEC concluded that the system engaged in insider trading and had inadequate compliance policies but filed only a Section 21(a) report and required no disgorgement or penalties) with *SEC v. Wagner*[17] (where a former director self-reported his trading in advance of a merger but was still required to disgorge his trading profits and pay prejudgment interest).[18]

The second enforcement policy concern involves parallel proceedings—an SEC investigation with a parallel criminal inquiry. The SEC, as a matter of policy, does not disclose whether it has referred a matter to DOJ or is working with criminal prosecutors. Rather, it relies on standard Form 1662, which it furnishes to all witnesses. That multi-page form notes, in part, that matters may be referred to criminal prosecutors.

The SEC's reliance on Form 1662 was recently approved by the Ninth Circuit Court of Appeals in *US v. Stringer*.[19] There, the court held that, as long as SEC and DOJ prosecutors do not make affirmative misrepresentations to witnesses, the agencies are free to work together, conceal the existence of the criminal inquiry to make sure that witnesses and known targets of the criminal investigation testify fully before SEC investigators, and set up potential witnesses for false statement charges. In view of the increasing criminalization of securities laws cases, counsel will have little choice but to assume the worst—and advise clients accordingly.

The third enforcement policy concern involves corporate penalties. In 2006, the SEC issued a release on this topic, detailing the factors it used to decide whether a corporate penalty should be imposed and, if so, how large that penalty should be. Last year, SEC Chairman Christopher Cox announced a new corporate penalty settlement procedure. Under the new policy, the Commission will direct its staff regarding an appropriate corporate penalty before settlement negotiations begin. Critics argue that the policy undercuts SEC staff, will further slow the settlement process, and impedes meaningful discussions with defense counsel. Even more troubling, a review of corporate penalty cases suggests no uniform standards.

Not surprisingly, there have been repeated calls for enforcement policy reform. Stakeholders from Congress to a sitting SEC Commissioner have asked that the Enforcement Division adopt uniform standards and procedures, much like those adopted in the US Attorney's Office Manual; revise its cooperation policies; convene a new Wells Commission to review settlement procedures; and consider other fundamental issues. Unfortunately, these recommendations have gone largely unheeded.

Conclusions

The trends reflected in the SEC's current enforcement program can be expected to continue. At times, enforcement will be extremely aggressive

with rapid case preparation and legal theories that push the edge of the law, such as in the insider trading and FCPA cases. At other times, enforcement will be very slow and backward looking, as in many of the financial fraud cases. On still other occasions, enforcement will result in shifting standards, such as in some insider trading and option backdating cases. The SEC is also likely to continue its emphasis on insider trading, the FCPA, and financial fraud and to expand into areas related to subprime.

Awareness of these trends is critical to avoiding entanglement in investigations or enforcement actions and, ultimately, liability. To avoid, or at least minimize liability, issuers and their directors, officers, and counsel should carefully review key compliance programs, such as those for insider trading, the FCPA, and fraud detection. Continued employee education in these areas is critical, particularly in view of the comments in the *Lucent* case.

Understanding these trends is also critical to any person facing an SEC investigation, which inevitably presents difficult choices that can have an impact far beyond the immediate investigation. When making those choices, each person should carefully consider, for example, whether cooperation is an appropriate path in view of the inconsistent results that it may yield. If cooperation is appropriate, the next strategic consideration is whether to waive privilege. The possibility of parallel proceedings must also be assessed in view of the increasing trend toward criminalization. A parallel criminal inquiry can have a significant impact on the issue of cooperation and resolution of the matter. At every turn, it is essential to critically examine Enforcement Division policies, procedures, and trends and their consequences.

Notes

1. 3:05 CV 1747 (PCD) (D. Conn. March 21, 2007).
2. No. 07 Civ. 7044, slip op. (S.D.N.Y. Feb. 26, 2007).
3. Civil Action No. 03 CV 2230, slip op. (S.D. Ca. May 30, 2007).
4. Case No. 1:07-cv-01774-PKC (S.D.N.Y. 2007).
5. Civil Action No. 07 Civ. 3628 (SAS) (S.D.N.Y. May 8, 2007).
6. Civil Action No. 07-CV-04427 (S.D.N.Y. May 30, 2007).
7. Civil Action No. 07-cv-9606 (S.D.N.Y. Oct. 29, 2008).
8. *SEC v. Stummer,* Civil Action No. 1:2008 cv 03671 (S.D.N.Y. April 17, 2008) (defendant hacked into brother-in-law's computer and traded on information from system).
9. *U.S. v. Jefferson*, Case No. 1:07-cr-00209 (E.D. Va. Filed June 4, 2007).
10. *U.S. v. Kay*, 359 F.3d 738 (5th Cir. 2004); *U.S. v. Kay*, 2007 WL 3088140 (5th Cir. Oct. 24, 2007). *See also In the Matter of Bristow Group, Inc.* Administrative Proceeding File No. 3-12833 (Sept. 26, 2007) (same).
11. *SEC v. Lucent Technologies, Inc*., Civil Action No. 07-092301 (D.D.C. Filed Dec. 21, 2007).
12. *SEC v. Nortel Networks, Corp.*, Civil Action No. 07-CV-8851 (S.D.N.Y. Oct. 15, 2007).
13. *SEC v. Federal Home Loan Mortgage Corp.*, Case No. 07-cv-1728 (D.D.C. Sept. 27, 2007).
14. *See, e.g.*, *SEC v. Reyes*, No. C 06 84435 CRB (N.D. Cal. July 20, 2006).
15. Civil Action No. C-07-65121 (N.D. Cal Filed Dec. 4, 2007).
16. Release No. 574461 (March 6, 2008).
17. Civil Action No 07-22123 (D.D.C. Filed Dec. 7, 2007).
18. Civil Action No. 07-CV-8851 (S.D.N.Y. Oct. 15, 2007). Compare also *SEC v. The BISYS Group, Inc.* 07 Civ. 4010 (KMK) (S.D.N.Y. May 23, 2007) (where defendant, whose financial results over a three-year-period were overstated by $180 million, was able to settle for only a books and records injunction, disgorgement, and prejudgment interest but no penalty) with *SEC v. Nortel Networks* (where a company that improperly accelerated revenue recognition offered "significant cooperation" during the investigation and consented to a books and records injunction but still paid a civil penalty of $35 million).
19. No. 06-30100, 2008 WL 901563 (9th Cir. Apr. 4, 2008).

Director Compensation in Turbulent Times

By Amy L. Goodman and Gillian McPhee

Recent turmoil in the mortgage and credit markets, and the resultant difficulties at a number of large financial institutions, have once again led some to ask the question: "Where was the board of directors?" Those raising this question have inquired about the nature and extent of the board's involvement in overseeing the risks associated with sub-prime lending and other activities at these institutions. Although current questions have been directed at oversight of risk assessment and risk management, these questions really represent the latest formulation of a recurring question for boards of directors: how to strike the delicate balance between engaging in effective oversight without crossing the line into micromanagement.

It is generally understood that the appropriate role of the board of directors is one of diligent oversight, and that directors cannot, and should not, be involved in the day-to-day operation of a company's business. Recent events, however, have underscored that serving on a public company board of directors in the 21st century involves more than simply attending meetings. More than ever before, being a director involves a substantial commitment of time and effort, a commitment for which directors are increasingly receiving significant compensation.

In the nearly six years since the passage of the Sarbanes-Oxley Act of 2002, boards of directors have become more active and engaged, with directors taking on increased workloads and facing heightened exposure to liability. According to one estimate, many directors now devote upwards of 250 hours annually to serving on a board.[1] Moreover, there is no question that today, directors are operating in a more precarious environment that presents greater risks of litigation than in the past. Director compensation necessarily should reward directors not only for their time, but also for the risks attendant to board service in the current environment.[2]

With greater responsibility and increased exposure to litigation has come a significant rise in the compensation paid to non-management directors for board service. (Members of management generally do not receive compensation for serving as a director.) According to the 2007 Spencer Stuart Board Index, which examines practices at S&P 500 companies, board retainers among the S&P 500 rose 73 percent from 2002 to 2007, and total average compensation topped $211,000 in 2007.[3] Only in the past two years has director compensation begun to level off, with more modest annual increases.[4] In addition, there is greater transparency relating to director compensation as a result of the comprehensive amendments to the Securities and Exchange Commission's executive and director compensation disclosure rules, which took effect with the 2007 proxy season.

At the same time, attracting and retaining qualified directors has become more difficult.[5] Competitive compensation can be an important recruiting tool, although some have cautioned that "excessive" compensation may compromise independence.[6] The listing standards of the New York Stock Exchange, for example, note that "[t]he board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary."[7] Similarly, the American Bar Association Corporate Director's Guidebook advises that boards "should be sensitive to and avoid compensation policies or corporate perquisites that might impair the independence of . . . non-management directors."[8]

Cash Compensation

Historically, meeting fees have been the most common form of director compensation. Meeting fees remain a majority practice today, but in the past several years, there has been a movement away from them, as evidenced by surveys, articles and other governance commentary. As an alternative to or in conjunction with meeting fees, companies

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have begun to rely more heavily on annual retainers. Retainers are typically paid in cash, and some companies offer directors the option of deferring all or a portion of the annual retainer into a cash account or into equity.

According to the NACD Director Compensation Report: 2007-2008 (the NACD Report), a report published by the National Association of Corporate Directors and The Center for Board Leadership in collaboration with Pearl Meyer & Partners that compares non-management director compensation at 1200 companies in five revenue groups, there was a "continued decline" in the use of meeting fees in 2007, with fees falling between three percent and eight percent among companies in all but one revenue group.[9] The 2007 Spencer Stuart Board Index found that 52 percent of boards at S&P 500 companies paid board meeting fees and 54 percent paid committee meeting fees in 2007. These figures are down from 70 percent and 64 percent, respectively, five years ago.[10] At the same time, as noted in the NACD Report, the majority of companies continue to pay meeting fees, with 51 percent of the 200 largest companies paying them.[11] The proportion of companies paying for meeting attendance was highest among "medium" companies (companies with revenues of $1 to $2.5 billion)—where 74 percent followed this practice—and ranged from 63 percent of "large" companies (those with revenues between $2.5 and $10 billion) to 67 percent at the smallest companies surveyed (companies with revenues between $50 and $500 million).[12]

The trend away from meeting fees is attributable in part to an impetus for simplification in the structure of director compensation programs. However, it also has deeper roots in good governance practices. The increased emphasis on the importance of an engaged, diligent board has contributed to the growing view that attendance is a core requirement of board membership, and therefore, that directors should not be paid simply for coming to meetings. Moreover, directors are devoting more time to board activities outside the context of meetings—studying materials for meetings, counseling the CEO and senior management, keeping abreast of relevant company developments and attending educational programs. Finally, there has been a recognition that the work of directors, and the value they bring to the table, goes well beyond attendance at meetings.

All of these factors have led governance experts and companies to question the continued appropriateness of meeting fees. For example, the so-called "Breeden Report" issued in response to the accounting scandals at WorldCom, Inc. recommended that WorldCom directors receive a substantial annual cash retainer with no meeting fees.[13] The report recommended a retainer that was "large enough to provide attractive compensation for high quality board members" in lieu of the company's previous, modest cash retainer and quarterly meeting fees, which collectively were "not adequate to reflect the responsibilities and time commitment that should be expected of a director of one of the country's largest companies."[14] Getting rid of meeting fees also avoids the definitional question of what constitutes a meeting, as well as practical issues such as whether to pay differential compensation for in-person versus telephone meetings and how to compensate directors in circumstances where they attend a portion, but not all, of a particular meeting. Trends demonstrate that a number of companies have eliminated meeting fees over the past several years. Some companies now include explicit statements in their annual proxy disclosure, or in their corporate governance documents, that they do not pay meeting fees. For example, General Electric Company states expressly in its governance documents that "[t]here are no meeting fees because attendance is expected at all scheduled board and committee meetings, and at the Annual Meeting of Shareowners, absent exceptional cause."[15]

Historically, companies have paid meeting fees for attendance at board as well as committee meetings. More recently, however, there also has been a pronounced trend toward differential compensation, or paying more for roles that place additional demands on directors. These roles typically include serving on, or chairing, particular committees—usually the three "key" committees (audit, compensation, and nominating/governance), with increased compensation most frequent for the audit committee. Other roles that typically command extra compensation include serving as a presiding/lead director or independent chair.

With directors devoting more time to board service outside of meetings, a compensation structure that includes meeting fees—either as a substitute for, or supplement to, an annual retainer—may no longer be suited to the realities of public company board service in the 21st century. Meeting fees may

encourage individuals to view board service as a succession of discrete, intermittent activities—quarterly, or even monthly, meetings—rather than an ongoing service that requires a comprehensive, "big-picture" outlook and the performance of an oversight function. An annual retainer may be a more effective tool for encouraging directors to view board service this way, and fostering a focus on the long-term interests of the company and its stockholders.

Equity Compensation

Most governance commentators recommend that director compensation consist of a mix of cash and equity.[16] Together, these two components serve to provide directors with a combination of currently payable, pre-determined compensation and long-term compensation designed to align directors' interests with those of a company's stockholders. In this regard, equity serves the important function of ensuring that directors have "skin in the game."[17]

In recent years, as the emphasis on aligning director and stockholder interests has grown, companies have begun to pay a larger proportion of total director compensation in the form of equity. In 2007, more than 50 percent of the companies in all but one of the five revenue groups surveyed for the NACD Report paid at least half of their board compensation in equity. By contrast, a year earlier, only two of the five revenue groups surveyed included at least 50 percent equity as part of their total compensation mix.[18] In practice, grants are made on a director's initial election to the board, on an annual basis, or both. According to one 2007 survey, the prevailing practice among the 100 largest US public companies, by a large margin, was to use annual grants exclusively.[19]

There is no "one size fits all" approach when it comes to the relative mix of cash and equity compensation or the terms of equity compensation. To be an effective tool for aligning director and stockholder interests, equity should constitute a meaningful portion of total director compensation. However, it should not be such a large component that directors look to increases in the company's stock price as the primary source of compensation for board service.[20] Just as the mix of cash and equity may differ from one company to the next, companies employ a range of practices with respect to vesting periods for equity awards. According to a 2007 Frederic W. Cook & Co. survey of non-management director compensation at the 100 largest companies listed on each of the New York Stock Exchange and the NASDAQ Stock Market, vesting periods of longer than a year were more common for equity grants made when directors join the board than for annual grants. For annual grants, slightly more than half of companies applied vesting periods of longer than one year.[21]

There is also no "one size fits all" approach when it comes to the types of equity that companies use to compensate directors. However, in the past few years, companies have begun using "full-value" equity awards, a term generally used to refer to awards other than stock options and stock appreciation rights. Full-value awards can take the form of stock granted outright, restricted stock, restricted stock units, deferred stock and deferred stock units, and performance stock and performance stock units. The popularity of stock options as a form of equity compensation for directors surged during the technology boom, but options have since fallen out of favor. According to the 2007 Spencer Stuart Board Index, just 42 percent of S&P 500 companies offered option plans for directors in 2007, down from a peak of 77 percent in 2002.[22]

Critics of stock options argue that options do not require directors to accept any economic risk and that options may encourage a short-term focus on a company's stock price. Although stock option grants for executives have been subject to similar criticisms, there is arguably a stronger justification for options in the executive compensation context due to the role of management, which is to focus (among other things) on company performance, both current and long-term. By contrast, because the role of the board is to oversee management of the company's operations in the long-term best interests of the company's stockholders, the argument for stock options as a form of director compensation is less compelling.

In evaluating director compensation, boards should consider the appropriate mix between cash and equity compensation and the reasons for their selected approach. In deciding what forms of equity to provide, consideration should be given to whether full-value awards rather than stock options may be a more effective tool for aligning the interests of directors with those of stockholders.

Stock Ownership Guidelines and Requirements

Stock ownership guidelines typically encourage—and in the case of stock ownership requirements, mandate—that directors attain a specified level of ownership in a company's stock. Some companies also have a retention requirement mandating that directors hold an established amount of stock for a specified period of time. Stock ownership and retention policies have garnered a lot of attention in the past several years as institutional investors and others have focused on the importance of directors having a meaningful ownership stake in the companies where they serve on the board. For example, organizations such as Business Roundtable recommend that directors own a meaningful position in a company's common stock and hold that stock for as long as they remain on the board.[23] Like equity compensation, stock ownership and retention policies align directors' interests with those of stockholders.

Typically, stock ownership guidelines or requirements take the form of a multiple of the annual retainer, and directors must achieve the threshold ownership level within a specified period of time after joining the board. The most common multiples are three to five times the annual retainer, and directors typically are given five years to meet the threshold.[24] Management directors are generally subject to separate guidelines or requirements, along with other executive officers.

In the last five years, the number of companies with stock ownership guidelines or requirements for non-management directors has grown substantially. Among the 1200 companies surveyed in the NACD Report, 45 percent disclosed that they had stock ownership guidelines or requirements in 2007.[25] The prevalence of stock ownership guidelines and requirements generally correlates with company size, with 76 percent of the 200 largest companies having them, as compared to about 19 percent of the smallest companies and 44 percent of "medium" companies.[26] By contrast, the NACD's report for 2002-2003 found that only about 20 percent of the 200 largest companies had stock ownership guidelines or requirements at that time.[27] According to the 2007 Spencer Stuart Board Index, among S&P 500 companies, 73 percent disclosed stock ownership guidelines or requirements for directors in 2007, an "all-time high."[28] This compares to 62 percent in 2006 and 52 percent in 2005.[29]

Companies have taken two approaches in addressing director stock ownership, with some companies adopting guidelines that simply encourage ownership of a specified amount of stock, as distinct from the firm requirements adopted by other companies. Stock ownership requirements obviously have more "teeth" and therefore, a company's stockholders may look on them more favorably and its directors may take them more seriously. By contrast, guidelines afford an additional measure of flexibility. Whether a company adopts requirements or guidelines, the ownership targets and the associated time frames for reaching the targets should be reasonable in light of directors' current stockholdings and financial circumstances, while at the same time providing for the attainment of a meaningful equity stake in the company. Company policies in this area should make it clear whether a company's provisions relating to stock ownership are "requirements" or "guidelines."

A growing number of companies also have adopted stock retention requirements. These requirements mandate that directors hold an established amount of stock for a specified period of time. Typically, this time period extends until a director meets the company's stock ownership guidelines or requirements, or until a director retires from the board (and occasionally, until a set date—such as a year or six months—after retirement). Some companies require directors to retain a percentage of shares acquired through option exercises and the vesting of equity awards for specified periods.

Stock retention requirements have not yet become a majority practice, but are looked upon favorably as a way of aligning the long-term interests of directors with those of stockholders. According to the Frederic W. Cook & Co. survey of the 100 largest NYSE and NASDAQ companies, 34 percent of NYSE companies and 13 percent of NASDAQ companies had stock retention requirements in 2007.[30] Boards that are considering adopting stock ownership guidelines or requirements, or that are reviewing existing policies in this area, should consider including as part of their policies a requirement that directors retain a specified amount of stock for the full term of their board service.

Perquisites and Other Benefits

As discussed above, the SEC's 2006 compensation disclosure rule changes have led to greater transparency about director pay, including enhanced disclosures about directors' perquisites. Companies must report directors' perquisites and other personal benefits that equal or exceed $10,000 in the aggregate in the "All Other Compensation" column in the Director Compensation Table in their annual proxy statements.[31] The proxy statement must identify each perquisite or personal benefit by type, and separately quantify in a footnote to the table any perquisite or personal benefit that exceeds the greater of $25,000 or 10 percent of the total amount of perquisites.[32]

In recent years, there has been a trend away from providing perquisites to directors, which has been accelerated by the SEC's new requirements. Perquisites have been criticized on the grounds that, among other things, they have no relation to corporate performance or the quality of director service. In addition, critics have argued that some overly generous perquisites may compromise independence. Because they result in directors being treated more like highly salaried employees than fiduciaries and representatives of a company's stockholders, perquisites—so the argument goes—align the interests of directors with those of management rather than stockholders. Organizations like the NACD have recommended that companies pay directors solely in the form of equity and cash, and that they "dismantle . . . existing benefit programs and avoid creating new ones."[33]

However, the NACD Report indicates that the prevalence of perquisites for directors in 2007 was highest at the 200 largest companies, even though this group "continue[s] to serve as the trend setters for board pay practices."[34] Among the 200 largest companies, 67 percent provided some form of perquisites or other benefits to their board members.[35] These perquisites included life or health insurance, company products or services, car-related perquisites, personal aircraft use, and other benefits including spousal travel, annual physicals, financial and tax preparation, and gift matching or charitable gifts. One perquisite that has all but disappeared from today's landscape in response to criticism is director retirement programs,[36] although some directors remain eligible for retirement benefits under legacy programs.

Many companies offer deferred compensation plans to provide flexibility for directors who may not wish to receive their cash compensation on a current basis. Deferred compensation plans permit directors to postpone the receipt and taxation of compensation until they retire from the board. Generally, directors have the option of investing amounts that are deferred into cash accounts, company stock or both. Some deferred compensation plans provide benefits to directors for deferring compensation into company stock, a practice that organizations such as the Council of Institutional Investors have frowned upon.[37]

Companies should consider whether it is appropriate to pay above-market interest on deferred compensation, and any above-market or preferential earnings on nonqualified deferred compensation must be disclosed in the Director Compensation Table.[38] In addition, companies should consider whether to offer the same investment alternatives to directors under any deferred compensation plans that they offer to employees under widely available deferral plans.

In 2007, matching and charitable gifts were the most common board perquisite among companies of all sizes, according to the NACD Report.[39] A matching gift program generally should not raise issues if it is offered to directors on the same terms available to all company employees. On the other hand, charitable award programs raise more issues. These programs permit directors to designate one or more charitable organizations to receive a donation of company funds—often as large as $1 million in the aggregate—upon a director's departure from the board or death. In addition to the criticisms cited above that apply to perquisites generally, charitable award programs have come under fire on the grounds that the amounts paid under the programs are excessive relative to the annual fees that directors receive for their service, that they bear no relationship to a company's corporate purpose, and that they lessen director oversight of other philanthropic activities by reducing the board's incentive to challenge management decisions relating to a company's other philanthropic activities.

When the SEC most recently amended its compensation disclosure rules, it specifically listed charitable award programs among the perquisites that companies must disclose.[40] Companies must

provide disclosure about the annual costs of payments (and promises of payments) under any charitable award program or director legacy program, as well as footnote disclosure about the total dollar amount payable under the program and the other material terms of the program.[41] Charitable award programs for directors are not as commonplace as they once were, due in part to the potential impact of charitable contributions on director independence.[42]

Disclosure issues aside, in the current environment, boards should reconsider the continued appropriateness of including perquisites as part of their director compensation program. Critics insist that perquisites are inconsistent with the role that directors play as fiduciaries and representatives of a company's stockholders. Moreover, perquisites are a "hot button" issue for stockholders and an easy target for criticism. In light of these considerations, and because the amounts involved are relatively minimal, boards may well decide that it is preferable to avoid most perquisites absent a compelling justification. To the extent that perquisites are part of a company's director compensation, the board should evaluate whether specific perquisites are appropriate and reasonable, and the impact that perquisites may have on director independence.

Setting Director Compensation

The board of directors should periodically review the company's director compensation in light of developments in the marketplace and the board's needs. In making decisions about director compensation, boards should focus on creating total compensation that is reasonable relative to directors' responsibilities and compensation at comparable companies. Boards should consider each element of compensation and how it, both individually and together with the other elements, furthers the goal of aligning directors' interests with those of stockholders. Boards should also be comfortable that a company's director compensation adequately rewards directors for the risks associated with board service, as well as their time and efforts.

The processes that boards follow for reviewing and approving director compensation vary. Typically, a committee of independent directors—either compensation or nominating/governance—assists the board in this endeavor and recommends proposed changes in compensation to the full board for approval. Delegating responsibility for director compensation to the compensation committee may make sense because this committee is accustomed to working on compensation issues and is likely to have a relationship with an outside compensation consultant who can provide market data. Other companies may determine that the nominating/governance committee is the appropriate committee to handle director compensation because this committee focuses on the recruitment of directors, director qualifications and governance matters more generally. Whichever committee is selected, SEC rules require that companies include a narrative description in their annual proxy statements of their processes for considering and determining director compensation, including information about any committee charged with responsibility for this area, and the role played by executive officers and any compensation consultants.[43] In addition, a company's governance guidelines should address the substance of and process for determining director compensation.

In setting their own compensation, directors face an inherent conflict of interest. The corporate laws of Delaware and other states outline procedures for boards to follow in approving any so-called "interested transactions."[44] These procedures are designed to safeguard board decisions on interested transactions from challenges based on conflict-of-interest grounds and generally require that a majority of the disinterested directors approve an interested transaction. Although director compensation is the classic example of an interested transaction, a board has no disinterested directors when it comes to director compensation. This suggests that the full board should pay particular attention to the process of setting its own compensation and seek to arrive at compensation that is fair and reasonable under the circumstances. The responsible committee should review and consider all relevant information, including data on market trends and compensation paid by comparable companies. Some boards may find it useful to engage an independent compensation consultant for the purpose of collecting and analyzing this information, and a consultant can also advise on specific compensation-related issues that may arise from time to time. Given the conflict-of-interest concerns, it may be preferable to approve director compensation, and changes in compensation, at the full board level.

Conclusion

Almost six years after the passage of the Sarbanes-Oxley Act, a number of director compensation practices that were once considered "emerging" have become mainstream at large companies. This is true, for example, of stock ownership guidelines and requirements. Over the next several years, we can expect to see the practices that have now firmly taken hold at these companies "trickle down" to mid-sized and smaller companies. This "trickle down" effect is already evident in a number of areas, such as the decreasing use of meeting fees.

There is no question that trends in compensation practices are important in structuring a director compensation program, as are so-called "best practices" like director stock ownership. It is equally important, however, for a company's board to consider the company's individual circumstances. The result should be a compensation program that appropriately compensates highly qualified board members and aligns their interests with those of the company's stockholders.

Notes

1. Committee on Corporate Laws, American Bar Association Section of Business Law, *Corporate Director's Guidebook* 49-50 (5th ed. 2007).

2. For additional discussion about steps that directors can take to perform their responsibilities effectively in a more precarious environment, *see* Gibson Dunn & Crutcher LLP, *The Director Settlements at Enron and Worldcom; Lessons for Directors* (Jan. 18. 2005), available at *http://www.gibsondunn.com/Publications/Pages/TheDirectorSettlementsatEnronandWorldcomLessonsforDirectors.aspx*.

3. Spencer Stuart, *Spencer Stuart Board Index* 27-28 (2007), available at *http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_FINAL.pdf*.

4. National Association of Corporate Directors, The Center for Board Leadership, and Pearl Meyer & Partners, *NACD Director Compensation Report: 2007-2008* 6 (2008); *Spencer Stuart Board Index*, at 28.

5. *See, e.g.*, Grant Thornton LLP, Press Release, *65 percent of Senior Financial Officers of Public Companies Say It's Harder Today to Recruit Directors, Citing Sarbanes-Oxley Act, Increased Director Liability* (Aug. 26, 2005).

6. *See*, *e.g.*, Richard C. Breeden, *Restoring Trust, Report to The Hon. Jed S. Rakoff, The United States District Court For the Southern District of New York On Corporate Governance For The Future of MCI, Inc.*, Recommendation 3.01, at 78 (2002), attached as Exhibit 99.2 to Form 8-K of WorldCom, Inc. filed September 2, 2003 ("Members of the board should be paid a substantial annual cash retainer reflecting (i) the significant required commitment of time, and (ii) the limitations against serving on other boards. An annual retainer should reflect the responsibilities of the board, but not be so large as to impair a board member's independence or willingness to challenge management or to resign.").

7. NYSE Listed Company Manual, Section 303A.09 (2008).

8. Committee on Corporate Laws, American Bar Association Section of Business Law, *Corporate Director's Guidebook*, at 89.

9. *NACD Report*, at 4, 12.

10. *Spencer Stuart Board Index*, at 28-29.

11. *NACD Report*, at 12.

12. *Id*.

13. *See* Richard C. Breeden, *Restoring Trust,* Recommendation 3.01, at 78. The Breeden Report also criticized the cash component of WorldCom's director compensation program on the grounds that the "negligible cash fee led directors to look to stock appreciation as their principal form of compensation." *Id*. at 77.

14. *Id*. at 77.

15. General Electric Company, *The Nominating and Corporate Governance Committee Key Practices* Key Practice 2.a, available at *http://www.ge.com/company/governance/board/nominating_comm_key_practices07.pdf*; *see also* Intel Corporation 2003 proxy statement 13 (Apr. 2, 2003) ("The Board ceased the payment to each director of per-meeting fees. . . . The Board's current view is that per-meeting fees are inappropriate, because attendance at all meetings is expected, and a substantial amount of the Board's work is done in Committee meetings and outside of formal meetings.").

16. *See, e.g.*, *NACD Report*, at 2 (citing National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Director Compensation* (2001)); The California Public Employees' Retirement System, *Core Principles of Accountable Corporate Governance* Core Principle D.6 (June 15, 2007), available at *http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf*; The Council of Institutional Investors, *The Council of Institutional Investors Corporate Governance Policies* Section 6.1 (Sept. 18, 2007), available at *http://www.cii.org/UserFiles/file/council%20policies/Redesigned%20CII%20Corp%20Gov%20Policies%201-29-08(1).pdf*; Business Roundtable, *Principles of Corporate Governance 2005* 25 (Nov. 2005), available at *http://www.businessroundtable.org/pdf/CorporateGovPrinciples.pdf*.

17. *See* Timothy Annett, *Better Option: Charles Elson's Prescription for Ailing Boards*, The Wall Street Journal (Dec. 19, 2002).

18. *NACD Report*, at 13.

19. Shearman & Sterling LLP, *Corporate Governance Survey: Director and Executive Compensation* 15 (2007).

20. The Breeden Report cited this as a flaw in the director compensation program at WorldCom. *See* note 13 above.

21. Frederick W. Cook & Co., Inc., *2007 Director Compensation: NASDAQ 100 vs. NYSE 100* 14 (2007), available at *http://www.fwcook.com/alert_letters/2007_Director_Comp.pdf.*

22. *Spencer Stuart Board Index*, at 28.

23. Business Roundtable, *Principles of Corporate Governance 2005*, at 25. Other organizations recommending that directors have a meaningful ownership stake in companies where they serve on the board include the Council of Institutional Investors and TIAA-CREF. *See The Council of Institutional Investors Corporate Governance Policies*, at Section 5.13a; Teachers Insurance and Annuity Association-College Retirement Equities Fund, *TIAA-CREF Policy Statement on Corporate Governance* Section V.A.6 (5th ed.), available at *http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf.*

24. *NACD Report*, at 23.

25. This includes companies that require board members to hold at least some equity-based awards until retirement. *See id.*

26. *Id.*

27. National Association of Corporate Directors, *Director Compensation Survey: 2002-2003* 11 (Apr. 2003).

28. *Spencer Stuart Board Index*, at 30.

29. *Id.*; *see also* Spencer Stuart, *Spencer Stuart Board Index* 21 (2005).

30. Frederick W. Cook & Co., Inc., *2007 Director Compensation: NASDAQ 100 vs. NYSE 100*, at 13.

31. SEC Regulation S-K, Item 402(k)(2)(vii).

32. *Id.* & instruction 3.

33. *NACD Report*, at 2 (citing National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Director Compensation* (2001)).

34. *NACD Report*, at 24.

35. *Id.*

36. *See, e.g.,* National Association of Corporate Directors, *2003-2004Director Compensation Survey* 5 (2004) (stating that director retirement programs "remain[ed] a negligible presence in pay packages, as companies . . . have increasingly abandoned their use in the face of criticism from governance forces." As of the time of the survey, the percentage of companies with retirement programs ranged from one percent to three percent.).

37. *The Council of Institutional Investors Corporate Governance Policies*, at Section 6.9b.

38. SEC Regulation S-K, Item 402(k)(2)(vi)(B).

39. *NACD Report*, at 24.

40. SEC Regulation S-K, Item 402(k)(2)(vii)(G). Prior to its 2006 rule amendments, the SEC had taken the position that charitable award programs were disclosable as part of directors' compensation. *See Executive Compensation Disclosure*, Release No. 34-31327 (Oct. 16, 1992) (Charitable award programs "clearly relate to the directors' board service, and the premiums can be considerable, particularly relative to the amounts paid annually to directors, and are material in assessing the relationship of directors to the registrant.").

41. SEC Regulation S-K, Item 402(k)(2)(vii)(G) & instruction 1.

42. *See, e.g.*, Committee on Corporate Laws, American Bar Association Section of Business Law, *Corporate Director's Guidebook*, at 90 (citing charitable award programs, along with director retirement programs, as examples of perquisites that were "once somewhat widespread" but "have generally been reduced or discontinued as forms of director compensation.").

43. SEC Regulation S-K, Item 407(e)(3).

44. *See, e.g.*, 8 Del. Code Ann. §144 (2008).

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