

**CORPORATE GOVERNANCE:
ADVISING DIRECTORS ON HOW TO BE
EFFECTIVE DIRECTORS UNDER NEW
AND CHANGING STANDARDS FOR
DIRECTOR CONDUCT**

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Setting precedent.

HOW TO BE AN EFFECTIVE DIRECTOR

- **Being an effective director is a learned skill**
- **Standards for directors change over time, and have changed dramatically since the adoption of Sarbanes-Oxley in 2002 – this is the legacy of the Enron collapse and other high profile corporate scandals**
- **Directors must continually evaluate how to best meet their fiduciary, legal, ethical, and corporate governance responsibilities**

HISTORICAL MISPERCEPTION OF AN OUTSIDE DIRECTOR'S ROLE

- **Open treated as passive, not active**
- **Senior management generally had almost exclusive power to manage the corporation's affairs, as a practical matter**
- **Mistaken belief that proper role for outside directors was to generically (and unobtrusively) oversee the corporation's affairs and, if and when asked, approve major transactions or other significant managerial decisions**

HISTORICAL ROLE OF NON-MANAGEMENT CORPORATE DIRECTORS

- **Misperception of an outside director’s role was furthered because:**
 - **CEO usually selected the outside directors (the “Good ‘Ole Boy Network”)**
 - **Monarch-like CEOs and other senior officers were given great latitude in running the corporation, without much interference from directors or stockholders**
 - **By custom and tradition, outside directors lacked resources to obtain their own guidance and assistance**

NEW AND CHANGING ROLE OF DIRECTORS: SARBANES-OXLEY AND OTHER CORPORATE GOVERNANCE REFORMS

- **Reaction to recent scandals (such as Enron) caused by the failure of American business to provide ethical leadership**
- **Intended to restore investor confidence**
- **Raise issues of what it means to be a public company in the U.S.**

NEW SARBANES-OXLEY REQUIREMENTS

- **CEO/CFO certifications of Form 10-Q and Form 10-K**
- **§404: (1) Management's assessment of internal control over financial reporting, (2) attestation opinion by auditors of management's assessment, and (3) audit opinion by auditors on internal control over financial reporting**
- **Audit Committee – expanded duties; independence and “financial expert” on Audit Committee**
- **Code of ethics**

OTHER NEW SOX/SRO REQUIREMENTS

- **New director independence, corporate governance, and disclosure requirements**
- **Real time disclosure -- revised Form 8-K, shorter filing deadlines, etc.**
- **Auditor independence reforms**
- **New disclosure requirements for off balance sheet transactions and non-GAAP (pro forma) financial information**
- **No actions to influence or mislead auditors**

SOX § 404 AND PCAOB AUDITING STANDARD NO. 2

- **Establishes performance and reporting requirements regarding management's assessment, and audit of management's assessment, of internal control over financial reporting**

SARBANES-OXLEY – § 404 – INTERNAL CONTROL OVER FINANCIAL REPORTING

- **CEO/CFO assessment and report on internal control**
- **External auditor must attest to management’s assessment in the annual report (requires framework such as COSO – emphasis on “Tone at the Top”)**
- **Integrated approach: external auditor (1) “attestation” opinion; (2) audit opinion on internal control; and (3) audit opinion on financial statements**

SOX § 404 AND PCAOB AUDITING STANDARD NO. 2 - continued

- **Auditor must render adverse internal control audit opinion (vs. qualified opinion) upon finding “material weakness”**
- **Substantial increase in auditing costs**
- **Possible increased liability for auditors, audit committee and board? (duty of care/oversight)**

SHIFT OF CORPORATE GOVERNANCE TO INDEPENDENT DIRECTORS

NYSE and NASDAQ rules adopted, as mandated or approved by the SEC

- **Required independence of a majority of the board**
- **Required executive sessions of independent directors**
- **Audit Committee, Nominating/Governance Committee, and Compensation Committee must be composed entirely of independent directors**

INDEPENDENT DIRECTOR OVERSIGHT RESPONSIBILITIES

- **Required independent director oversight of**
 - **Employee whistle-blower complaints**
 - **Lawyer whistle-blower complaints**
 - **Waiver of corporate code of conduct**
- **NYSE requires a presiding director for executive sessions of non-management directors**
- **NYSE company must disclose name and how to contact presiding director, or independent directors as a group**

LEGAL COMPLIANCE – OVERSIGHT BY INDEPENDENT DIRECTORS

- **Federal sentencing guidelines – “Thompson Memo” – factors considered include existence and adequacy of company’s legal compliance program (reasonably designed to detect, deter, and disclose legal violations)**
- **2004 amendments require directors to be knowledgeable about content and operations of compliance and ethics programs**

SARBANES-OXLEY AUDIT COMMITTEE REFORMS

- **All members of the Audit Committee must be independent (no other compensation from Company; no affiliates)**
- **Audit Committee must establish procedures for handling complaints regarding accounting or auditing (anonymous “whistleblower”)**
- **Must disclose whether or not there is a “Financial Expert” on Audit Committee (if not, why not)**

SOX -- INDEPENDENT DIRECTORS – AUDIT COMMITTEE

- **New “boss” of external auditor -- sole authority over the hiring, firing, compensation, and supervision of external auditors**
- **Expanded responsibilities for internal controls, risk management, Form 10-Q and 10-K filings, internal auditing function, review of financial statements and MD&A, earnings - press releases and guidance**
- **Pre-approval of all audit and non-audit services**

CHANGING STANDARDS FOR DIRECTOR CONDUCT

- **After Sarbanes-Oxley, greater scrutiny of the role of directors and their liabilities**
- **Fear of potential liabilities**
- **Directors must understand their fiduciary duties and act in a manner to be an effective director, and to protect themselves against potential liabilities**

POTENTIAL LIABILITIES OF DIRECTORS

- **Potential liability for breach of common law fiduciary duties**
 - *Duty of Loyalty*
 - *Duty of Care*
- **Potential liability for violating or permitting the corporation to violate statutes (federal securities laws, RICO, Internal Revenue Code, ERISA, etc.)**

DIRECTOR'S FIDUCIARY DUTIES – THE DUTY OF LOYALTY

- Directors must act with “an undivided and unselfish loyalty to the corporation”
- In a breach of loyalty case, no Business Judgment Rule protection
- Once a plaintiff proves a conflict of interest existed, the burden of proof shifts to the defendant directors to show the “**fairness**” of the transaction
- Avoid “fairness” test if disinterested directors approve in good faith after full disclosure

TO SATISFY THE FIDUCIARY DUTY OF CARE, DIRECTORS MUST

- **Act in good faith**
- **Act in a manner reasonably believed to be in the best interests of the corporation**
- **Make decisions based upon reasonably adequate information and deliberation**
- **Discharge duties with the care that a person in a like position would exercise under similar circumstances**

THE BUSINESS JUDGMENT RULE

- **A presumption of the courts that in making a business decision the board of directors acted:**
 - **Independently**
 - **With due care and on an informed basis**
 - **In good faith**
 - **In the honest belief that their actions were in the best interests of stockholders**

THE BUSINESS JUDGMENT RULE

- **Protects only informed decisions**
 - **Directors must inform themselves of all relevant information reasonably available to them**
 - **Standard for determining whether a business judgment was an informed one is *gross negligence***
- **No protection of business judgment rule if directors abdicated their functions or failed to act**

BUSINESS JUDGMENT RULE – EXCULPATORY CLAUSES AND “GOOD FAITH”

- Risk of personal liability of directors – not a “gloom and doom” story – the business judgment rule is “alive and well”
- Directors must demonstrate that conduct (whether constituting ordinary or gross negligence) was in “good faith”
- DGCL §102(b)(7) -- corporate charter may excuse directors from personal liability for duty of care arising out of gross negligence (must show “good faith” and no intentional wrongdoing)

BUSINESS JUDGMENT RULE – “GOOD FAITH” STANDARD

- Delaware – “good faith” standard is not a negligence concept (“not in good faith” conduct is more egregious than ordinary negligence and gross negligence, but less egregious than intentional conduct)
- “Not in good faith” – subjective state of mind, as evidenced by overt conduct; there is “a sustained or systematic” failure of the board to exercise oversight”; or consciously ignoring duties; or knowing or deliberate indifference (“we don’t care about the risks”)

RISE IN USE OF SPECIAL BOARD COMMITTEES

- **Litigation committees consisting of independent directors (derivative suits); who is “independent”?**
- **Special transaction committees (for transactions with an “interested party,” such as a director or controlling stockholder of the company)**
 - **“Entire fairness standard” is used to judge interested party transactions**
- **Special transaction committees must have the ability to negotiate at arms-length and to say no**
- **Special internal investigation committees**

CAREMARK INT'L. CASE -- THE FIDUCIARY DUTY OF CARE REQUIRES AN OVERSIGHT FUNCTION

- **Directors' oversight function – requires good faith attempt to reasonably monitor the corporation's affairs, ensuring that appropriate information and reporting systems are in place**
- **Sustained or systematic failure to exercise oversight (failure to attempt to assure reasonable information and reporting systems exist) will establish *lack of good faith* that is a necessary condition to liability**

FIDUCIARY DUTIES – *DISNEY* CASE -- “GOOD FAITH” RE: CEO COMPENSATION

- **Disney -- Validated claim for breach of duty of good faith despite protections of “charter option” DGCL liability waiver**
- **Establishes potential board liability for “rubber stamping” compensation decisions of executives**
- **Prohibits “ostrich-like” or “we don’t care about the risks” attitude; lack of “good faith” may create liability**

DIRECTOR PROTECTION BY PROPER CONDUCT—DUTY OF CARE

- **Be committed—vigilance, dedication, time, effort**
- **Prepare in advance for, attend and participate in board and committee meetings**
- **Make due inquiry (ask questions, follow up, read)**
- **Use experts (legal, auditors, bankers, consultants),**
- **Become knowledgeable about the company, its financial statements, its industry and competitors**
- **Make good faith effort to assure that reasonable information and reporting systems exist**

TO SATISFY THE DUTY OF CARE

- **Make compliance and ethics programs a priority**
- **“Due diligence” -- spend time necessary to evaluate key issues**
- **Assess risk and fortify internal controls (and assure appropriate disclosure of risks)**
- **Keep records to prove you did the right thing, including good minutes of meetings (don't take notes, or destroy notes when minutes are finalized)**
- **Keep up--CPE in accounting and corporate governance**

RECOMMENDED BOARD GOVERNANCE PRACTICES – CEO COMPENSATION

- **Treat executive hiring/compensation decisions like merger decision – to avoid *Disney* liability**
- **Obtain reasonable info and spend adequate time to ensure “good faith”**
- **Maintain adequate “paper trail” of informed decision-making process**
- **Establish monitoring and reporting system to provide board with timely and accurate information upon which to base decisions**

DIRECTOR PROTECTION BY PROPER CONDUCT – DUTY OF LOYALTY

- Prevent a breach of the duty of loyalty by **avoiding conflicts of interest** and **self-dealing**
- Approve conflict transactions by **independent committee** of directors (or majority of disinterested directors)
- Use separate legal counsel and advisers for the independent committee of directors
- Document efforts to overcome conflict of interest problems

RECOMMENDED BOARD GOVERNANCE PRACTICES

- **Annual review of internal controls and disclosure controls**
- **Periodic meetings of independent directors only (NYSE and NASDAQ rules require)**
- **Audit committees meet with both internal and external auditors**
- **Boards should be constructively engaged with management to ensure appropriate development, execution, and monitoring of company strategies**
- **New directors receive board orientation (consider mandatory CPE)**

CHARACTERISTICS OF GOOD DIRECTORS

- **Understand financial reporting**
- **Committed to being a working director**
- **Devote necessary time to carry out duties (limit boards)**
- **Recognize heavier reliance by public**
- **Use common sense and good business judgment**

INSULATE DIRECTORS FROM LIABILITY BY CHARTER/CONTRACT

- ***Contractual Liability Protection***
 - **Charter option provision – DGCL §102(b)(7)**
 - **Indemnification – bylaws and agreements**
 - **D&O insurance – (especially, pay legal expenses as incurred)**

PRACTICAL IMPACT ON BOARD MEMBERS

- **More time required (some may reduce their number of directorships to 3 or 4)**
- **New demand for “financial expert” (a *de facto* requirement)**
- **More difficult to find qualified independent directors (increased time commitment; fear of liability?)**
- **Possible increased D&O insurance premiums and underwriting analysis**

ADVISING DIRECTORS

- **Make sure that the company has correct “Tone at the Top”**
- **Be willing to put in time, effort and commitment (satisfy duty of care)**
- **Understand that the risks of conflicts of interest, and fraudulent or misleading financial disclosure can be minimized by good Audit Committee and Board oversight**
- **Understand the requirements of director conduct in order to be protected by business judgment rule**
- **Make sure company has adequate “charter option” provisions, indemnification, and D&O insurance**

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