

**ADVISING THE INDEPENDENT DIRECTOR
IN THE POST-ENRON ERA —
THE NEW NICHE PRACTICE OF CORPORATE LAWYERS**

Prepared By

**Michael M. Boone
Haynes and Boone, LLP**

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1. INTRODUCTION

1.1. *Enron Legacy.* In the aftermath of the 2001-2002 corporate scandals (most notably Enron) and the resulting loss of public confidence in the capital markets, the U.S. Congress conducted lengthy investigative hearings to determine the root causes of these problems. Based on these investigations, Congress concluded that these corporate debacles stemmed from major weaknesses in: (i) the American system of corporate governance; (ii) the accounting and audit functions of public companies; (iii) the federal public disclosure system; (iv) the business ethics of public companies; and (v) the standards of conduct of lawyers, auditors and investment professionals. *The Congressional lawmakers took special note of the blatant failure of the boards of directors of these problemed companies to detect and deter the alleged corporate wrong-doings underlying these scandals.* The federal regulators became convinced that the corporate scandals could largely have been prevented if the outside directors had properly monitored the affairs of their companies on an informed basis and with an independent eye. They perceived that the breakdown in corporate governance was largely attributable to an unhealthy “coziness” between outside directors and management. Indeed, some critics even held the view that many CEOs were guilty of stacking their boards of directors with their old cronies who in turn did little more than rubberstamp management’s agenda. To remedy these perceived deficiencies and to restore investor confidence in corporate America, the federal regulators moved quickly to fashion appropriate regulatory reforms.

1.2. *Post-Enron Regulatory Reforms to Correct Perceived Weaknesses in Corporate America .*

A. *Sarbanes-Oxley Act of 2002 (“SOA”) and the Securities and Exchange Commission (“SEC”) Rules and Regulations (“SEC Rules”) Implementing the Provisions of the SOA.* Signed into law by President Bush on July 30, 2002, the SOA is an aggressive legislative effort to prevent future corporate debacles of the Enron-type even to the point of encroaching into areas that were once considered to be only within the purview of state corporation laws. In due course, the SEC has adopted regulations to implement the SOA reforms.

B. *Listing Requirements of the Organized Securities Markets.* Following the lead of Congress, the New York Stock Exchange Inc. (“NYSE”) and The NASDAQ Stock Market Inc. (“NASDAQ”) adopted, as mandated or approved by the SEC, new governance requirements for listed companies that were likewise aimed at thwarting future occurrences of Enron-type failures. These reforms are imposed through the New York Stock Exchange Listing Requirements (“NYSE Rules”) and The NASDAQ Stock Market Inc. Listing Requirements (“NASDAQ Rules”) respectively. Like the SOA, the NYSE Rules and the NASDAQ Rules also intrude into the internal affairs of corporations notwithstanding the generally recognized purview of state corporation laws.

1.3. *Number One Regulatory Objective: Expand the Role of Independent Directors.*

The most noteworthy aspect of these regulatory reforms is the expansion of the role

and authority of independent directors. In that regard, the post-Enron regulatory reforms accomplish two very significant things. First, they purposely shift key governing power away from corporate management and to the independent directors. The regulators saw a need to place independent directors in a position whereby they would have control and authority over these key governance functions, free from any undue influence of management. By so diluting the power of management, there is no doubt but that a major paradigm shift has occurred in the governance structure of most U.S. publicly-held companies. Second, the regulatory reforms impose, some directly and some indirectly, specific oversight duties on the independent directors of public companies with respect to financial accounting functions, ethical conduct policies and legal compliance and reporting systems. Suffice it to say, the federal regulators were not about to wait to see if state legislative bodies would appropriately address the corporate governance and director oversight problems identified in the Congressional investigatory proceedings.

Corporate America has responded to these reform efforts. It is very evident today that independent directors (i) are much more involved in overseeing conduct of their companies and management and (ii) are devoting more time toward carrying out their board duties. Additionally, a recent study by the Corporate Executive Board found that 82% of public companies have boards comprised of at least 80% independent directors and 96% of companies have boards comprised of at least 60% independent directors. These independence percentages are in stark contrast to the percentages prior to the enactment of Sarbanes-Oxley. A 2001 survey by Institutional Shareholder Services, a watchdog for institutional shareholders, revealed that less than 60% of companies had boards comprised of a simple majority of independent directors. That said, it is interesting to note that a majority of Enron's board were independent, and in the year prior to Enron's bankruptcy, a national magazine had recognized the Enron board as being one of the best boards in corporate America!

In sum, the post-Enron regulatory reforms have sent a clear message to corporate America that independent directors are expected to be in control of critical governance matters and to exercise independent, objective judgment in overseeing the legal conduct of the company and its management. Today, regulators and investor alike have much greater expectations for independent directors in the fulfillment of their oversight responsibilities.

- 1.4. *Increasing Utilization of Legal Counsel by Independent Directors.*** Independent directors are increasingly seeking the advice of legal counsel in connection with the performance of their legal responsibilities under the new federal regulatory mandates as well as under state corporate fiduciary laws. As part of the post-Enron regulatory reforms, independent directors (through their audit committee, compensation committee and nominating/governance committee functions) are authorized to retain their own third-party experts (including legal counsel) for assistance in performing their committee responsibilities. Moreover, special committees ("Special Committees") of independent directors (established to handle stockholder derivative claims, interested party transactions or internal investigations) are likewise authorized to retain independent advisors to help guide them. Additionally, independent

directors turn to corporate lawyers for advice in deciding whether to accept a board seat and even how and when to resign from a board. While general counsel staffs are normally expected to be their first line of legal advisors, independent directors often find it more appropriate to use independent legal counsel due to confidentiality and conflict of interest issues. For that reason, the legal representation of independent directors is becoming a niche practice for many law firms just like “special committee” representation has developed into a major practice area over the prior two decades. For a discussion of these developments, see the following articles that appeared in the August, 2004 issue of *The Business Lawyer*: Geoffery C. Hazard, Jr. and Edward B. Bock, *A New Player In The Boardroom: The Emergence Of The Independent Directors’ Counsel*, and E. Norman Veasey, *Separate and Continuing Counsel For Independent Directors: An Idea Whose Time Has Not Come As A General Practice*.

- 1.5. ***Scope of Outline.*** This outline examines the broad legal responsibilities of independent directors in the post-Enron era. In doing so, the outline focuses on (i) how the post-Enron reforms have expanded the governance and oversight responsibilities of independent directors, (ii) how these new oversight responsibilities relate to their fiduciary duties under state corporate law, especially the duty to monitor and (iii) how Special Committees are properly formed and operated under state corporate laws. Finally, the outline looks at the advice that independent legal counsel is often called on to give to independent directors in today’s litigious climate.

2. MAJOR SHIFT OF CORPORATE GOVERNANCE POWER AND AUTHORITY TO INDEPENDENT DIRECTORS BY THE POST-ENRON REGULATORY REFORMS

- 2.1. ***Introduction.*** Set forth below is a review of the post-Enron regulatory requirements that have placed greater governance power and authority in the hands of independent directors and in turn, have increased their legal responsibilities.
- 2.2. ***Required Independence of a Majority of the Board of Directors.*** Under NYSE and NASDAQ listing requirements, independent directors, rather than corporate insiders, must constitute a majority of the board of directors of publicly-held companies (NYSE Rule 303A.01 and NASDAQ Rule 4350(c)) except in the case of (i) “controlled companies” (where a majority of the voting power is held by an individual, a group or another company), (ii) foreign companies and (iii) companies in bankruptcy proceedings. While SOA does not directly regulate the independence of board members, Section 301 of SOA does require that all members of a listed company’s audit committee be “independent” directors.

Below is a discussion of the definitions of “independence” under the NYSE and NASDAQ rules. These definitions focus on independence from management. As discussed under Section 5.5 below, state corporate laws have their own standard of “independence” with respect to the formation and operation of Special Committees.

NYSE Definition of Director “Independence”

To be deemed an independent director, NYSE Rule 303A.02 requires that the company’s board of directors affirmatively determine that a director has “no material relationship” with the company either directly or “as a partner, shareholder or officer of an organization that has a relationship with the company”. The basis for a board determination that a director does not have a “material relationship” has to be disclosed in the company’s annual proxy statement. However, the NYSE Rules do allow for boards to adopt and disclose categorical standards concerning material relationships for determining whether a director is independent.

The NYSE rules provide that the following persons are not eligible to be considered independent: (i) an employee or an immediate family member of an executive officer, (ii) a person who receives or is an immediate family member of a person who receives, compensation directly from the company (excluding director compensation or retirement benefits for prior service which is not contingent on future service) of more than \$100,000 per year, (iii) a person (or an immediate family member of a person) who is affiliated with or employed by a present or former internal or external auditor of the company, (iv) a person (or an immediate family member of a person) who has been part of an interlocking compensation committee arrangement and (v) a person who is an executive officer or an employee (or an immediate family member of a person who is an executive officer) of a company that makes payments to, or receives payments from, the listed company for property or services in an amount that in a single fiscal year exceeds the greater of 2% of such company’s consolidated gross revenues or \$1 million.

The NYSE Rules impose a “cooling off” period of three years before a person, who had a relationship that impaired his or her independence (or who is an immediate family member of a person who had such a relationship), can be considered eligible to be deemed an independent director.

NASDAQ Definition of Director “Independence”

NASDAQ Rule 4200(A)(15) defines “independent director” to be a person who has no relationship which would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. This Rule identifies six categories of people who would not be considered to be independent: (i) a person who is employed by the company or by any parent or subsidiary of the company; (ii) a person who is a family member of an individual who is employed by the company or any parent or subsidiary of the company as an executive officer; (iii) a person who is, or has a family member who is, a current partner of the company’s outside auditor or was a partner or employee of the company’s outside auditor who worked on the company’s audit at any time during any of the past three years; (iv) a person who accepts, or is a family member of a person (other than an employee of the company or a parent or subsidiary of the company) who accepts, payments from the company or any of its affiliates in excess of \$60,000 during the current or any of the past three fiscal years of the company; (v) a person who is, or has a family member who is, “a partner in, or

a controlling shareholder or an executive officer of,” any organization to which the company made, or from which the company received, payments for property or services that exceed 5% of the recipient’s consolidated gross revenues or \$200,000, whichever is more, for the current or any of the past three fiscal years; or (vi) a person who is, or has a family member who is, employed as an executive officer of another company where any of the company’s executive officers serve on the other company’s compensation committee.

2.3. *Required Executive Sessions of Independent Directors.* NYSE Rule 303A.03 and NASDAQ Rule 4350(c) require non-management directors (which, in most cases, will be only the company’s “independent” directors) to meet on a regular basis without the presence of the CEO and other members of management who are directors. If an executive session does include non-management directors who are not also independent, then an executive session consisting solely of independent directors is required to be held at least once a year. This executive session meeting requirement is clearly intended to promote candid discussions among the independent directors about issues that they might be reluctant to discuss in the presence of management.

2.4. *Required Independence of the Members of Three Most Important Board Committees.* Under the post-Enron regulatory reforms, the three most important board committees (the audit, compensation and nominating/governance committees) are required to be composed solely of independent directors.

A. *Audit Committee.* Section 301 of SOA and Rule 10A-3 promulgated thereunder by the SEC mandate the establishment of an audit committee consisting solely of independent directors. Section 301 of SOA defines “independent director” to be a director who does not accept, directly or indirectly, any compensation from the company (except for his or her services as a director) and is not an “affiliated person” of the company (i.e. a person who, directly or indirectly, controls, is controlled by, or is under common control with, the company). Section 301 of SOA also requires that audit committees be authorized to retain independent legal advisors and other third-party consultants to assist it in carrying out its duties.

The listing requirements of the NYSE and NASDAQ require an audit committee to consist of a minimum of three independent directors. The NASDAQ Rules also provide that a person may not serve on an audit committee if he or she has participated in the preparation of the company’s financial statements during the prior three years. Without question, of all the committees regulated by the post-Enron reforms, the audit committee has been assigned the broadest array of responsibilities. Attached hereto as Appendix A is an outline of an audit committee charter that reflects the broad responsibilities of audit committees under the NYSE Rules.

B. *Nominating/Governance Committee.* NYSE Rule 303A.04 requires listed companies (excluding controlled companies) to establish a “nominating/corporate governance committee” composed entirely of “independent directors.” This

committee is charged with overseeing the corporate governance of the company. The Rule provides that the charter of the committee should set forth the committee's purpose and its goals and responsibilities. In the case of the former, the rule requires that at minimum the committee's purposes must be to identify persons qualified to serve as directors consistent with criteria approved by the full board and to either (i) select the director nominees for election at the next annual meeting of stockholders or (ii) recommend to the board the selection of such nominees. The Rule also requires that the committee be given the responsibility of developing and recommending to the board the corporate governance principles of the company and of overseeing the evaluation of board and management. The committee's charter must give the nominating/corporate governance committee the sole authority to hire and fire search firms for use in identifying director candidates.

NASDAQ Rules do not require a charter for a nominating/governance committee and in the case of governance/nominating function, the NASDAQ Rules simply require that the nomination of a company's directors be determined by either a majority of the independent directors or by a nominations committee comprised solely of independent directors.

NYSE Rule 303A(9) requires listed companies to adopt governance guidelines. This responsibility is usually assigned to the nominating/governance committee. These guidelines are not intended to be "one size fits all" but focus at a minimum on "key areas of universal importance." Each listed company's annual report is required to state that its corporate governance guidelines (together with the charters of its most important committees and the company's code of business conduct and ethics) are posted on its website and available in print to any stockholder who requests them. Although each company is expected to develop its own policies for corporate governance, the NYSE commentary to this proposed rule identifies seven topics that a company's guidelines must address. The NASDAQ Rules do not address the establishment as a company's governing principles. Attached hereto as Appendix D is an outline of the governance issues typically addressed by companies in their governance principles under the NYSE Rules.

Attached hereto as Appendix B is an outline of a nominating/governance committee charter that reflects the broad responsibilities of nominating/governance committees under the NYSE Rules.

- C. *Compensation Committee.*** NYSE Rule 303A.05 requires listed companies to establish a compensation committee composed entirely of independent directors. The rule provides that the purpose and responsibilities of the committee are to (i) discharge the board responsibilities in setting the compensation of company executives and (ii) produce an annual report on executive compensation for inclusion in the company's proxy statement for its annual stockholders meeting in accordance with SEC rules and regulations. Further, the committee is to (i) review and approve the company's goals and objectives with respect to the CEO's

compensation, (ii) evaluate the CEO's performance against such goals and objectives and (iii) set the CEO's compensation based on that evaluation. Additionally, the committee is required to annually conduct a self-evaluation of the committee's performance. The charter is also required to grant the committee the sole authority to retain and terminate any consulting firm that assists in establishing executive and director compensation.

NASDAQ Rule 4350(c)(3) requires the compensation of the CEO and all executive officers be approved by either a majority of the independent directors or by a compensation committee comprised solely of independent directors.

Attached hereto as Appendix C is an outline of a compensation committee charter that reflects the broad responsibilities of compensation committees under the NYSE Rules.

3. INDEPENDENT DIRECTOR OVERSIGHT RESPONSIBILITIES ARISING UNDER THE POST-ENRON REGULATORY REFORMS.

3.1. *Introduction* The post-Enron regulatory reforms have expanded, directly and indirectly, the oversight functions of independent directors with respect to legal compliance by the company. These reforms also impose on the principal executive officer ("CEO") and the principal financial officer ("CFO") certain certification and assessment duties that are aimed at assuring the accuracy of the company's public disclosures and financial reporting. *Interestingly, these requirements of corporate executives have a spill-over effect on an independent director's fiduciary duty to monitor.* These federally mandated duties of corporate executives clearly fall within the oversight responsibilities of directors. Accordingly, boards are expected to be proactive in periodically satisfying themselves that the duties imposed on the CEO and CFO are being reasonably performed with the help of information reporting systems that are reliable and effective. Below is a review of the oversight responsibilities of independent directors and of the CEO and CFO with respect to a public company's legal compliance and financial reporting that arise under the new federal regulatory scheme.

3.2. *Independent Director Oversight Responsibilities Under the Post-Enron Regulatory Reforms.*

A. *Required Independent Director Oversight of Employee Whistle-Blower Complaints.* Under Section 301 of the SOA, a company's audit committee (which consists solely of independent directors) is required to establish procedures for receiving, retaining and responding to anonymous and confidential complaints from employees regarding accounting, internal controls and auditing matters. *In view of how Enron's management handled the infamous Sherron Watkins complaint about Enron's accounting practices, Congress saw a need for independent directors rather than management to have sole control over the receipt and handling of whistle-blower complaints.* The audit committee is given total discretion in setting its policies and procedures.

- B. Required Independent Director Oversight of Lawyer Whistle-Blower Complaints.** Under Section 307 of SOA, Congress attempted to correct what it perceived to be weaknesses in the way lawyers handled matters involving wrongful conduct by a client. Lawyers who provide legal advice to a public company with respect to SEC matters and who become aware of evidence of an actual violation of (i) securities laws, (ii) fiduciary duty laws or (iii) other federal or state law, have a duty to report the information “up the ladder.” The lawyer must report first to the chief legal officer of the company and if this does not result in an appropriate response, then up to the CEO. If both of these give unsatisfactory responses, the lawyer must then report the matter to the audit committee (or if one is in place, a Qualified Legal Compliance Committee consisting solely of independent directors) or to the board of directors. *In sum, the independent directors, as opposed to management, have been made the final arbiter of how a company will handle a lawyer’s discovery of an unlawful conduct.*
- C. Required Independent Director Oversight of Waiver of Corporate Code of Conduct.** NYSE Rule 303A.10 and NASDAQ Rule 4350(n) require that listed companies adopt a code of conduct for directors, officers and employees. A code is to cover such things as conflicts of interest, compliance with law and the reporting of unethical behavior and illegal conduct. *Any waiver of the code for a director or an executive officer must be approved by the board (of which the independent directors are the majority) and then promptly disclosed to the public through a Form 8-K filing.* Except for SOA and related SEC requirements that public companies disclose in their annual reports whether or not they have adopted a code of ethics applicable to the CEO, CFO and controller (and, if not, why not), the post-Enron regulatory scheme does not require the independent directors to oversee a company’s code of conduct. However, in view of the new expectations of independent directors, it would be wise for independent directors to satisfy themselves as to the adequacy and effectiveness of their code of conduct. The SEC regulations require that (i) a code be reasonably designed to deter wrongdoing and to promote ethical conduct including making proper public disclosures and (ii) all amendments to a code be promptly disclosed to the public.
- D. Required Public Access to the Independent Directors.** The NYSE commentary to its Rule 303A.03 requires that a director (“**Presiding Director**”) preside over executive sessions of the non-management directors (see Section 2.3 above) and that the name of the Presiding Director be identified in the Company’s annual proxy statement. *Most importantly, the company is also required to disclose in its annual meeting proxy statement how a stockholder or other interested party can contact the Presiding Director or the non-management directors as a group. What this means is that interested parties are provided a way by which they can communicate their concerns to the independent directors.* There is no comparable provision in the NASDAQ Rules.

3.3. *Internal Controls, Disclosure Controls and Procedures and Management Certification and Assessment Responsibilities Under the Post-Enron Regulatory Scheme as They Relate to the Independent Director’s Duty to Monitor*

- A. *Overview.*** The new regulatory scheme is aimed at holding corporate management and directors accountable for the accuracy of corporate disclosures. In particular, the SOA has focused on the CEO and CFO because they are directly responsible for the way a company operates, including compliance with applicable laws and regulations.
- B. *Required CEO/CFO Certification of the Accuracy of 10-Qs and 10-Ks.*** Section 302(1) through (3) of the SOA requires the CEO and CFO of public companies to certify the accuracy of annual reports on Form 10-K and quarterly reports on Form 10-Q. Securities Exchange Act of 1934 (“*Exchange Act*”) Rules 13a-14 and 15d-14 that implement Section 302 require that the CEO and CFO certify in such reports that: (i) the signing officers have reviewed the report; (ii) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading and (iii) based on such officer’s knowledge, the financial statements and other information included in the report fairly presents in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the report.
- C. *Required CEO/CFO Certification of the Quality of Internal Controls.*** Section 302(4) requires the CEO and CFO to certify in such 10-Q and 10-K reports that they (i) are responsible for establishing and maintaining internal controls over financial reporting, and (ii) have designed such internal controls over financial reporting to ensure that material information relating to the company and its subsidiaries is made known to the CEO and CFO by others within those entities. SEC Rules 13a-15 and 15d-15 implement Section 302(4).
- D. *Required CEO/CFO Certification of the Quality of Disclosure Controls.*** Rules 13a-14 and 15d-14 require the CEO and CFO to certify in such 10-Q and 10-K reports that they (i) have designed such disclosure controls and procedures to ensure that material information is made known to them on a timely basis, (ii) evaluated the effectiveness of the disclosure controls and procedures within 90 days prior to the filing date, and (iii) presented in the filing their conclusions about effectiveness of the disclosure controls. These duties are intertwined with their duties described in Section 3.3.
- E. *Required CEO Compliance Certification to NYSE.*** NYSE Rule 303A.12 requires the CEO of each listed company to annually certify to the NYSE that such person is not aware of any violation by the company of the NYSE corporate governance listing requirements. This certification must be disclosed by the company in its annual report to stockholders. There is no similar certification required by NASDAQ Proposed Rules.

- F. *Required Management Assessment of Internal Controls.*** Section 404(a) of the SOA mandates that each company’s Form 10-K shall contain an internal control report that (i) states the responsibility of management for establishing and maintaining adequate internal control systems and (ii) contains management’s assessment, at year-end, of the effectiveness of such controlling status. Section 404(b) requires the external auditor to attest to and report on management’s assessment of such internal control systems.
- G. *Required Maintenance and Assessment of Disclosure Controls.*** Rules 13a-15 and 15d-15 require all companies that file reports under the Exchange Act to (i) maintain disclosure controls and procedures and (ii) within the 90-day period prior to the filing date of each report certified (as described in Section 3.3 and 3.4 supra) conduct an evaluation of the effectiveness of those controls with the participation of the company’s management, including the CEO and CFO.
- 3.4. *Independent Director Oversight Responsibilities Under the Federal Sentencing Guidelines.***
- A. *Federal Sentencing Guidelines.*** The United States Sentencing Guidelines for Organizations (“Sentencing Guidelines”) were originally promulgated in 1991 in an attempt to influence corporate behavior – both before and after wrongdoing occurs – by providing for lesser sentencing sanctions against companies which implement legal compliance programs that are adequately designed to detect and deter corporate criminal conduct. The so-called Thompson Memo from the Deputy Attorney General Larry Thompson in 2003 identified nine factors that federal prosecutors will consider in making charging decisions with respect to a business organization. One of these factors is the existence and adequacy of the organization’s legal compliance program. In evaluating the adequacy of such a program, the government takes into account, among other things, whether the compliance program is reasonably designed to detect, deter and disclose legal violations and whether it has a sound history of effectiveness.
- B. *2004 Amendments.*** In November, 2004, the Sentencing Guidelines were amended in the aftermath of the corporate scandals that spawned the post-Enron regulatory reforms. *These amendments were aimed at strengthening the requirements of legal compliance programs and impose greater duties on directors and officers in implementing and monitoring compliance programs. The amendments require, among other things, that (i) directors be “knowledgeable about the content and operations of the compliance and ethics programs,” (ii) the person in charge of the compliance program have direct access to the board (governing body), (iii) directors take the compliance training programs and (iv) the effectiveness of the company’s compliance programs be evaluated annually.*
- C. *Expectations of Compliance Programs After the Caremark Case and the 2004 Amendments.*** Directors are being challenged more and more in court over whether they have breached their duty to monitor under state corporate law when

their company is found to have engaged in unlawful conduct. Most noteworthy is the infamous *In re Caremark Int'l, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (“**Caremark**”) case in which the plaintiff-stockholders sued the directors derivatively for damages arising out of the directors’ alleged failure to detect and deter fraudulent activities of the company’s employees which resulted in major civil and criminal fines against the company as well as other sanctions. The *Caremark* court said

“... relevant and timely information is an essential predicate for satisfaction for the board’s supervisory and monitoring rule ... any rational person attempting in good faith to meet [his or her] organizational governance responsibility would be bound to take into account [the Sentencing Guidelines] ... a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists ...”

The defendant directors escaped personal liability because they had put in place a legal compliance program that the court found to be reasonable in large part because it followed the Sentencing Guidelines.

Suffice it to say, the *Caremark* decision along with the amended Sentencing Guidelines have had and are continuing to have a significant impact on the way corporate America approaches legal compliance. The growing expectation is that boards of directors will be hands on in establishing and monitoring the effectiveness of a company’s legal compliance programs with respect to the wide array of federal and state laws that the company operates under such as antitrust, securities, foreign corrupt practices, and environmental laws. Some boards have even created a legal compliance officer position who reports directly to the directors about the effectiveness of their compliance programs.

3.5. Summary of Federally Imposed Oversight Functions Below is a summary of the oversight functions arising under the regulatory reforms that require appropriate attention by independent directors’ in fulfilling their fiduciary duty to monitor under state corporate law.

A. Reporting and Compliance Functions.

- Internal Controls
 - 404 Assessment
 - Officer Certification
- Disclosure Controls and Procedures
 - Disclosure Committee
 - Officer Certification

- Whistle-Blowing Procedures
 - Company Employees
 - Company Lawyers
- Legal Compliance Programs
 - Federal Sentencing Guidelines
- Code of Conduct
- NYSE Certification

B. *Governance Functions.*

- Audit Committee
- Compensation Committee
- Governance Committee

4. DIRECTOR’S DUTY TO MONITOR THE AFFAIRS OF THE COMPANY.

4.1. *Overview.* The federal regulation of the oversight and governance of public companies (via the post-Enron regulatory scheme) needs to be considered in the context of the fiduciary duties of directors under state corporation laws. By imposing specific oversight tasks on independent directors, the post-Enron federal regulatory reforms have intruded into what was once thought to be exclusively within the jurisdiction of state corporate laws as if to say that short-comings in state corporation laws has required this intrusion. To be sure, while directors are charged by state corporate statutes with the responsibility of overseeing the affairs of the corporation (*e.g.*, Delaware General Corporation (“DGCL”) Law §141; Texas Business Corporation Act (“TBCA”) Art. 2.41), state corporate statutes generally provide little, if any, guidance as to what these oversight responsibilities actually require of directors. Instead, the scope of a director’s oversight responsibilities under state corporate law has been largely left to judicial interpretation. Unfortunately, there have been only a handful of cases that have considered a director’s duty to monitor (which is a subset of the duty of care). So, practically speaking, there is limited guidance on the scope of this duty.

That said, it is still true that directors are not expected to be directly involved in the day-to-day management and operations of the corporation. Instead, director oversight duties are generally considered to entail (i) selecting management and delegating appropriate operating authority to them (*e.g.*, contract execution authority), (ii) establishing major corporate strategies and policies (*e.g.*, ethical conduct policies for the company), (iii) making major corporate decisions (*e.g.*, declaration of dividends, stock issuances and acquisition transactions) and (iv) monitoring the conduct and performance of management and the company. From a litigation standpoint, it is the monitoring function that has drawn center stage attention in the post-Enron era.

4.2. The “Red Flag” Warning Standard for Directors in Monitoring Corporate Affairs.

In Graham v. Allis Chalmers Mfg. Co., 188 A2d 125 (Del. 1963), the defendant directors were not found liable in a derivative lawsuit that was based on their alleged failure to prevent antitrust violations perpetrated by the company because the court found that the directors had no knowledge of such wrongdoings. The Delaware Supreme Court essentially concluded that directors do not have an affirmative duty to be on the lookout for wrongful conduct by the corporation. The court explained that “Absent a cause for suspicion, there is no duty upon directors to install and operate a corporate system of espionage to ferret out wrong doing which they have no reason to suspect exists.” So, the Graham case has always stood for the proposition that in the absence of an obvious “red flag” warning of problems, directors have no obligation to search out wrongful corporate conduct.

4.3. New Judicial Expectations for Directors in Monitoring the Affairs of the Corporation. Beginning with the Caremark case, the Delaware courts have increasingly indicated that the “red flag” warning test expressed in Graham may no longer be the accepted standard for directors to follow. The Caremark court, in considering the Graham case, made this observation:

“[I]t would . . . be a mistake to conclude that our Supreme Court’s statement in Graham concerning “espionage” means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”

The Caremark case has been cited many times for the proposition that in fulfilling the duty to monitor, directors are expected to have in place reasonable systems for detecting wrongful conduct by the company. Inasmuch as independent directors are assigned specific oversight responsibilities (e.g. the oversight of employee whistle-blower complaints) under the post-Enron regulatory reforms, it is predictable that the courts may in the future find a failure to perform these federally mandated responsibilities to be a breach of the duty to monitor even though private individuals have no standing to sue under SOA to enforce its mandates. In sum, the duty to monitor arguably gives teeth to the post-Enron regulatory requirements from a private litigant’s standpoint.

4.4. The New Focus of Plaintiff-Stockholders in Challenging Director Conduct ¾ Duty to Monitor Claims. Over the past ten years, there has been an increasing number of duty to monitor cases alleging that defendant directors failed to detect and deter corporate wrongdoing (e.g. a failure to prevent the issuance of false and misleading financial statements or a failure to prevent illegal conduct by the corporation).

Plaintiff-stockholders enjoy an advantage in duty to monitor cases in establishing director liability as compared to other kinds of duty of care cases. The protection of the business judgment rule does not extend to directors with respect to claims challenging inaction by a board (absent a conscious decision to not act) but instead it only applies to claims challenging business decisions of a board (*see Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) and *Pereira v. Cogan*, 52 Fed. Appx. 536 (S.D.N.Y. 2003)). Since the business judgment rule shields directors against personal liability for ordinary negligence, the inapplicability of the business judgment rule to claims for failure to act means that plaintiff-stockholders need only prove simple negligence on the part of the defendant-directors in order to prevail in duty to monitor cases.

4.5. Importance of Demonstrating “Good Faith” Conduct.

A. Business Judgment Rule and Exculpatory Clauses. Today, a director’s risk of personal liability in duty of care cases is really not a doom and gloom story as some might suggest provided a director can demonstrate that his or her conduct (whether constituting ordinary or gross negligence) was in “good faith.” In the first place, the business judgment rule excuses the ordinary negligence of directors in making business decisions assuming a director has acted in “good faith.” Moreover, it is clear from recent Delaware cases that the business judgment rule is alive and well. Secondly, in the case of gross negligence, §102(b)(7) of Delaware General Corporation Law (adopted in 1986) permits stockholders to place in the corporate charter an exculpatory provision that excuses directors from personal liability for duty of care claims arising out of their gross negligence. (In a similar way, Art. 7.06 of the Texas Miscellaneous Corporation Act (“TMCA”) extends the same protection to directors of Texas corporations.) What an exculpatory charter provision does not do is insulate directors against liability for conduct amounting to intentional wrongdoing or an absence of good faith. As a result, the battleground in most duty to monitor cases (as well as other duty to care cases) is now over whether there was a presence or an absence of “good faith” conduct on the part of the defendant directors since intentional wrongdoing is usually not at issue.

B. Reliance on Experts. Section 141(e) of DGCL and Art 2.41C of the TBCA provide that directors are “fully protected” when they rely in “good faith” upon (i) books and records of the corporation, (ii) reports from management and (iii) reports of experts. See Section 6.6 below for a discussion of “good faith” reliance.

C. Indemnification. A director must have acted in “good faith” to be entitled to indemnification under Delaware (Section 145 Del. Gen. Corp. Law) and Texas (Art. 2.02-1B of TBCA) corporate laws.

4.6. “Good Faith” Standard. The Delaware Supreme Court in *E.I DuPont de Nemourer v. Pressman*, 679 A.2d 436 (Del 1996) observed that the meaning of good faith is not precise but instead, it “varies within the content.” Since “good faith” is not defined by

the Delaware or Texas corporate statutes, the courts have been left with the task of trying to explain the meaning of this standard of culpability. While there have been no Texas decisions regarding the meaning of “good faith conduct” (see *Gearhart Industries Inc. v. Smith International Inc.*, 741 F2d 707 (Fifth Circuit Court of Appeals 1984) for a discussion of Texas law), there have been several Delaware decisions. Unfortunately, the Delaware courts have brought some confusion to the matter. To begin with, the Delaware Supreme Court has indicated that “good faith” is a separate duty along with the duty of care and the duty of loyalty. See *Emerald Partners v. Berlin*, C.A. No. 9700 (Del. Ch. April 28, 2003) Aff’d 840 A2d 641 (Del. 2003). On the other hand, the Court of Chancery has taken the position that “good faith” is simply part of the duty of loyalty and not a stand-alone duty. See John Reed and Matt Niederman, “*Good Faith*” and *The Ability of Directors To Assert §102(b)(7) of the Delaware General Corporation Law As A defense To Claims Alleging Abdication, Lack Of Oversight And Similar Breaches Of Fiduciary Duties*, 29 Delaware Journal of Corporation Law 111 (2004) and Sean Griffith, *Good Faith Business Judgment: A Theory of Rhetoric In Corporate Law Jurisprudence*, 55 Duke L. J 1 (2005). Regardless, recent cases have helped shed some light on the meaning of the good faith standard in Delaware.

What we can glean so far from Delaware case law is that the “good faith” standard is not a negligence concept. Looking at the language of §102(b)(7) of DGCL and Art. 7.06 of the TMCA, it seems reasonable to conclude that “not in good faith” is conduct more egregious than ordinary negligence and gross negligence but less egregious than intentional misconduct. But where does the gross negligence standard stop and the “not in good faith” standard start? From a reading of the cases, “not in good faith” appears to go to a director’s state of mind/knowledge with respect to the alleged wrongdoing. The courts have explained “not in good faith” in the following ways:

- (i) there is “a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability” *Caremark*;
- (ii) “where a director consciously ignores his or her duties to the corporation ...” and where there is a “knowing or deliberate indifference ... to the director’s duty to act faithfully ...” *In re the Walt Disney Co. Derivative Litigation*, 825 A2d 275 (Del. Ch. 2003);
- (iii) Where director conduct evidences a “we don’t care about the risk” attitude *Emerald Partners v. Berlin*, 840 A2d 641 (Del. 2003);
- (iv) where the directors “knew that they were making material decisions without adequate information and without adequate deliberation . . .” *The Litigation Trust of MDIP Inc. v. Rapoport* 2005 U.S. Dist. LEXIS 9901 (D. Del. 2004);

- (v) where a board “consciously and intentionally disregard[s] responsibilities, *Official Committee of Unsecured Creditors of Integrated Health Services Inc. v. Elkins*, C.A. No. 20228-NC, (Del. Ch. August 24, 2004); and
- (vi) where a board “consciously disregard[s] known risks” that arose out of six years of FDA inspections that indicated regulatory compliance problems in the company’s production facilities. *In re Abbott Laboratories Derivative Shareholders Litigation.*, 325 F3d 795 (7th Cir. 2003)

These cases show that in determining a defendant director’s subjective state of mind/knowledge, the Delaware courts will look carefully at his or her overt conduct. While the *Caremark* case might suggest that “not in good faith” conduct (or stated differently, a director’s state of mind/knowledge) cannot be easily established by pointing to one single event as contrasted to showing a director’s repeated pattern of conduct, the court in *Guttman v. Huang*, 823 A2d 492, 506 (De. Ch. 2003) has perhaps described *Caremark* liability best by saying that it is where “...directors were conscious of the fact that they were not doing their jobs.”

5. RISE OF INDEPENDENT DIRECTOR COMMITTEES FORMED TO HANDLE STOCKHOLDER DERIVATIVE LITIGATION CLAIMS, INTERESTED PARTY TRANSACTIONS AND INTERNAL INVESTIGATIONS.

5.1. Overview. To meet certain objectives that are in keeping with state corporate fiduciary laws, Special Committees (consisting solely of independent and disinterested directors of a company) are often appointed by a board of directors: (i) to decide whether stockholder derivative claims should be pursued, (ii) to consider and negotiate the terms of a proposed interested party transaction with the company or (iii) to independently investigate and address an alleged internal problem within the company. Below is a discussion of the key legal facets of these three types of Special Committees as well as the meaning of “independence” under state corporate law with respect to the composition of the members of Special Committees.

5.2. Special Litigation Committees (“SLC”).

A. Derivative Litigation. Stockholder derivative litigation is a lawsuit brought by stockholders on behalf of the corporation against directors alleging that they have breached their fiduciary duties resulting in damages to the corporation. In most states, plaintiff-stockholders are required to make demand on the board of directors to assert the alleged claims before filing suit except where they can show that such a demand would be futile due to a lack of independence of the board. This demand requirement recognizes that the pursuit of such claims is an asset of the corporation and thus, the board of directors has the right to determine whether it is in the best interests of the corporation to pursue such claims. Directors are generally afforded protection under the business judgment rule in deciding whether stockholder derivative claims should or should not be pursued.

B. Use of Special Litigation Committees. When a shareholder makes a demand on a corporation with respect to a derivative claim against directors, often some or even all of the directors are made defendants and thus, they may be deemed to have a conflict of interest in considering whether the pursuit of the claims would be in the best interests of the company. In such event, it is common practice for a board to appoint a special litigation committee (“SLC”) consisting of independent and disinterested directors who are charged with the authority to investigate the claims and to determine if their pursuit would be in the best interests of the corporation. Discussed below are the corporate laws of Texas and Delaware pertaining to the effective use of SLCs.

Texas. Article 5.14 of the TBCA establishes the procedures for the handling of stockholder derivative litigation. In that regard, Article 5.14H requires a court to dismiss a stockholder derivative lawsuit if an independent/disinterested group (as prescribed by Article 5.14F of the TBCA) determines: (i) in good faith, (ii) after conducting a reasonable inquiry, and (iii) based on the factors that the group deems appropriate under the circumstances that continuation of such derivative proceeding would not be in the best interests of the corporation. An Article 5.14F determination must be made by (i) a majority vote of the independent and disinterested directors, (ii) a committee consisting of two or more independent and disinterested directors, or (iii) a panel of one or more independent and disinterested persons appointed by a court.

But, who is “independent” and “disinterested?” Article 1.02A(12) of the TBCA provides that a person will be considered “disinterested” if he or she (i) is not a party to the contract or transaction that is the subject of the claim or challenge, (ii) was “not materially involved in the conduct that is subject to the claim or challenge” and (iii) “does not otherwise have a material financial interest in the outcome of ... the disposition of the claim or challenge.” Most importantly, article 1.02A(12) provides that a director is not considered to be materially involved in the challenged conduct or to have a material financial interest in the outcome of the disposition of the subject claim or challenge ... solely by reason of the fact (1) that such director is named as “a defendant” in the subject derivative proceeding or is alleged to be “a person who engaged in the alleged misconduct” that is the basis for the subject derivative claims or (2) that such director approved or acquiesced in the alleged misconduct without receiving any personal benefit as a result thereof and the challenging person “fails to allege with particularity facts that if true, raise a significant prospect that the director would be adjudged liable by reason of such conduct” (emphasis added).

Under Article 1.02A(15) of the TBCA, a person is deemed “independent” if he or she: (i) is disinterested; (ii) is not an associate (other than by reason of being a director of the corporation or one or more of its subsidiaries or associates) or member of the immediate family of a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in the conduct that is subject to the claim or challenge; (iii) does not have (and an associate or member of the immediate family of such person must not have) a

business, financial, or familial relationship with a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in conduct that is subject to the claim or challenge, which, in each case, could reasonably be expected to materially and adversely affect the director's or other person's judgment with respect to the consideration of the disposition of the matter subject to the claim or challenge in the interests of the corporation; and (iv) is not otherwise shown, by a preponderance of the evidence by the person challenging the independence of the director or other person, to be under the controlling influence of a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in conduct that is subject to the claim or challenge. Article 1.02A(15) also identifies six circumstances that would not by themselves alone cause a director to be considered to have a relationship that would materially affect such person's judgment thereby making him non-independent.

Delaware. Unlike Texas, Delaware corporate statutes do not define "independent" or "disinterestedness" but instead, they have left these terms to be defined by the courts. Below is a discussion of the Delaware judicial standards that are relevant to the question of whether defendant-directors in a derivative proceeding can be considered independent and disinterested for the purposes of deciding whether the pursuit of the derivative action is in the best interest of the corporation.

Generally speaking, in considering the impartiality of directors in acting on a derivative demand, the Delaware Supreme Court in the Aronson case explained that a director is deemed to be an "interested" person (i) when he or she is on both sides of a transaction or expects to receive a personal financial benefit from the transaction in the sense of self-dealing as opposed to a benefit that devolves upon the corporation or all stockholders generally or (ii) when a corporate decision by that director will have a materially detrimental impact on the director, but not on the corporation and its stockholders. However, it should be noted that in deciding director impartiality, the Delaware Supreme Court has adopted different standards (i) for derivative actions challenging board decisions and (ii) for derivative actions challenging the failure of a board to act (i.e. conduct not involving a conscious decision by a board to act or to refrain from acting).

In the case of a challenge to a "board decision," the judicial standard announced in the Aronson case is whether the particularized facts alleged, reasonably show that (1) the directors were not disinterested and independent or (2) the challenged transaction was not the product of a valid exercise of business judgment. On the other hand, with respect to "failure to act" cases, the test is simply whether the directors in considering the demand, "can impartially consider its merits without being influenced by improper considerations" based on the particularized pleadings (Rales v. Blasband, 634 A.2d 927 (Del. 1993)).

The conundrum in Delaware law is how can directors be impartial in considering a derivative demand when they are deciding whether they should sue themselves.

However, it is well established in Delaware that a plaintiff-stockholder in a derivative action cannot cause a director to be deemed non-independent or non-disinterested by simply alleging wrongdoing by the director in the subject derivative action. In the *Aronson* case, the Delaware Supreme Court explained that “the mere threat of personal liability for approving a questioned transaction standing alone is insufficient to challenge “either disinterestedness or independence of a director” (emphasis added). The court concluded that “Unless facts are alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, a bare claim ... raises no legally cognizable issue under Delaware corporate law” (emphasis added). Except in “egregious circumstances,” the “mere threat” of personal liability does not constitute a disabling interest for a director considering a derivative plaintiff’s demand” (*Rattner v. Verisign*, 2003 Del. Ch. LEXIS 103)

In considering the impartiality of directors in acting on a derivative demand, a Delaware court’s assessment of the directors’ potential liability is based solely on the presumed truthfulness of the facts asserted by the plaintiff-stockholders in their pleadings. In making this assessment, the Delaware courts focus on two issues: (i) whether the particularized facts in the pleadings show a substantial likelihood that the directors breached their fiduciary duties as alleged by the plaintiff-stockholders and (ii) whether, if the corporation has an exculpatory charter provision that insulates directors from liability for a breach of the duty of care, the particularized pleadings set forth a sustainable, non-exculpated claim.

- 5.3. *Special Transaction Committees (“STC”).*** When a company is considering a business transaction with an interested party (e.g. a director or a controlling stockholder of the company), the board, especially if a majority of directors are also interested parties, will appoint a special transaction committee (“STC”) to consider and, if appropriate, negotiate the transaction. This common practice grew largely out of the *Weinberger* decision in 1983 discussed below.

Entire Fairness Standard. Under Delaware law, in cases challenging interested party transactions (e.g. a “going-private” transaction), the courts will apply the entire fairness standard in determining whether there has been a breach of the duty. The entire fairness standard requires that the courts actually examine the merits (fairness) of the challenged transaction as contrasted to the business judgment rule standard which only considers the reasonableness of the decision-making process not the merits of the decision. The entire fairness standard is a two-pronged test (i) whether there was “fair dealing” between the defendants and the company and (ii) whether a “fair price” was received by the company and its stockholders. *See Weinberger v. VOP Inc.*, 457 A2d 701 (Del. 1983).

“Fair Dealing” Requirement. “Fair dealing” pertains to whether the corporation was treated fairly in connection with the negotiations of the challenged transaction. Was the transaction negotiated on a simulated arms length basis and were the corporation and its directors and disinterested stockholders adequately represented in protecting their interests? How did the timing, structure and negotiation of the transaction affect

the interests of the corporation and its stockholders? These are the kinds of questions that are asked in determining the presence or absence of fair dealing. The concept of “fair dealing” contemplates that the corporation had the ability to bargain on an arms length basis and that the conflicted parties did not take advantage of the corporation through their position of control. On the other hand, the “fair price” element goes to an evaluation of the economic realities of the challenged transaction for the purpose of determining whether the company and its disinterested shareholders received full value in the transaction taking into account all relevant factors like comparable values, market conditions and future prospects. See *Kahn v. Tremont Corp.*, 694 A2d 422, 430 (Del. 1997).

Use of STC To Demonstrate Fair Dealing. The practice of establishing special transaction committees comes from the *Weinberger* case. The court in the *Weinberger* case indicated that satisfying the requirement of fair dealing would have been helped if the corporation had established “an independent negotiating committee of outside directors to deal . . . at arms length.” 457 A.2d at 706 n.7. Based on that statement, corporate lawyers began thereafter to recommend the use of special committees of disinterested directors to negotiate interested transactions on behalf of a corporation and its stockholders hoping that this step would help safeguard the transaction in case of subsequent legal challenges. See, *In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002)

The Organized and Properly Functioning STC Shifts the Burden of Proof. The mere existence of a special committee “does not itself shift the burden of proof.” See *Rabkin v. Olin Corp.*, C.A. No. 7547 (Del. Ch. 1990) *aff’d* 586 A.2d 1202 (Del. 1990) and *Rabkin v. Philip A. Hunt Chem.*, 498 A.2d 1099, 1107 (Del. 1985). The committee’s formation and operation must, in fact, reflect integrity, true independence and real bargaining power in negotiating the transaction on an arms length basis. Otherwise, the courts will not shift the burden of proof to the plaintiff-stockholders. See *Kragner v. Moffett*, 826 A2d 277 (Del. 2003). However, in *Emerald Partners v. Berlin*, C.A. No. 9700 (Del. Ch. April 28, 2003), *Aff’d* 840 A2d 641 (Del. 2003), the chancery court upheld the challenged transaction even though it found evidence of “unfair dealing” in the trial record because the defendants had shown that the transaction was in fact “fair.”

As to whether a special committee properly functioned, the Delaware Supreme Court in *Kahn v. Lynch Communications Systems, Inc.* reduced it to the following: the special committee must “(i) [be] truly independent, (ii) [be] fully informed and (iii) [have] the freedom to negotiate at arms length.” 638 A.2d at 1120. This means that the conduct of the special committee must reflect that the conflicted parties did not dictate terms, but that in fact, the committee had full bargaining power in negotiating the transaction. Likewise, the facts should demonstrate that the members of the committee were “fully informed and active [in] appropriately simulating an arms length transaction.” *Kahn v. Tremont Corporation*, 694 A.2d 422, 428 (Del. 1997). There the court concluded that a three-member committee did not function properly in part because one member never attended any meetings of the committee, another one missed two critical meetings and the third member and the only truly

active member had a significant business relationship with the controlling stockholder. In sum, if a special committee is to be credible, its members must demonstrate that they took their responsibilities seriously.

Set forth below are certain factors that the courts have focused on when determining whether a special committee has been properly organized and has properly functioned in order to shift the burden of proof to the plaintiff. For a complete analysis of the use of special committees, see *Uarallo, McErlean and Silberglid, From Kahn to Carlton: Recent Developments in Special Committee Practice*, 53 Bus. Lawyer 397 (1998).

- (1) *Independence of Advisors to the Committee.* Much like the requisite independence of the members of a special committee, a lack of independence on the part of the advisors to the committee also will jeopardize the credibility of the committee. In that regard, prior relationships between an investment banking firm or legal counsel and the conflicted parties can be expected to be looked upon with much disfavor by the courts in deciding if there was “fair dealing.” For instance, in the case of *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997), the court strongly criticized the retention of a financial advisor which had lucrative past dealings with the controlling stockholder and his affiliates. Likewise, legal counsel to the committee had previously represented an affiliate of the controlling stockholder.
- (2) *Committee Not Influenced by Interested Parties.* To demonstrate that it functioned properly, a special committee must act independently. This means that it must be free of the influence of the interested parties. Most assuredly, the conflicted party cannot dictate the terms of the challenged transaction. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985).

This means that interested parties must not engage in any conduct that would effectively undermine the ability of the special committee to negotiate freely or to walk away from the proposed transaction. Below are three cases in which such conduct was fatal to the defendant’s case.

A controlling stockholder’s threat to a special committee that it would veto any proposal other than its own was viewed as effectively taking away the bargaining power of the committee. The committee had no ability to “shop” the deal for a better offer. *Kahn v. Dairy Mart Convenience Stores, Inc.*, C. A. No. 12489 (Del. Ch. 1996).

A controlling stockholder’s threat to a special committee to launch a hostile tender offer at a price less than what was then being offered by the controlling stockholder in a proposed merger was viewed as depriving the special committee of the “power to say no.” “Blackmailing” a committee can be fatal to the claim of “fair dealing.” *Kahn v. Lynch Communication Systems, Inc.* 638 A.2d at 1120.

A controlling stockholder used an ultimatum to a special committee that it would proceed with a transaction without the committee's input if the committee did not accept the offer that was then being offered by the controlling stockholder in merger negotiations. The court viewed this as having caused the committee to lose its ability to negotiate on an arms length basis since it had in effect no other choices to pursue. See *American General Corp. v. Texas Air Corp.* C.A. No. 8390 (Del. Ch. 1988).

- (3) *Committee Has the Power to Negotiate at Arms Length and to Say No.* For a special committee to be properly functioning, the committee must have total freedom to negotiate on an arms length basis. Accordingly, a special committee should be under no compulsion to reach any agreement with the conflicted parties. In *First Boston, Inc. Shareholders Litig.* C.A. No. 10338, slip op. 68 (Del. Ch. 1990), the court said:

“It is the duty of directors serving on a [special] committee to approve only a transaction that is in the best interest of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such direction to achieve the best price that a fiduciary will pay if that price is not a fair price. Nor is it sufficient to get a price that falls within a range of ‘fair value’ somehow defined, if the fiduciary [or someone else] would pay more.”

And, in *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994), the court similarly noted that:

“The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price.” 638 A.2d at 1119. (emphasis added)

- (4) *Manner of Selecting Advisors to the Committee.* The special committee should select its own advisors. The selection of advisors can be flawed if the selections are based on the recommendations or direction of the interested parties. See *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, n. 6 (Del. Ch. 1996); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997); *Fort Howard Corp. Shareholders Litig.* C.A. No. 9991, slip op. at 30 (Del. Ch. 1988). While special circumstances may call for additional advisors, a special committee will normally retain its own legal counsel and financial

advisor. The conflicted parties should not participate in discussions with the advisors to the committee. See *Mills Acquisition Co. v. MacMillan*, 559 A.2d 1261, 1279-80 (Del. 1989).

5.4. *Special Internal Investigation Committees.* Due to the increased number of whistleblower complaints by employees, the increased activity of government regulators in investigating corporate wrongdoing, the expanded responsibilities of independent directors (especially the audit committee) in monitoring corporate conduct and the heightened sensitivity of auditors to accounting irregularities, boards of directors are more frequently encountering internal issues that raise the need for independent internal investigations. Some internal investigations may be readily handled by a company's general counsel staff. But when there are credible allegations of serious corporate wrongdoing (e.g. issuance of fraudulent financial statements or wrongdoing by corporate executives), it is usually prudent to appoint a Special Committee to conduct an independent investigation with the assistance of independent legal counsel, forensic accountants and other independent third-party advisors. The credibility of the findings and conclusions of a special internal investigation will depend on how thorough, impartial and fair the investigation was conducted and how impartial and fair the committee and its advisors were. Independency will be a key issue. Special internal investigation committees often face very sensitive and difficult issues ranging from questions about wrongdoing by key executives to the issue of whether to cooperate with government investigations. Most importantly, where wrongdoing is found, the committee has to decide what is the appropriate action to take. In sum, usually under very trying circumstances, special internal investigation committees have to be formed and operated in a manner that reflects independency and impartiality much in the same manner that a special transaction committee is expected to be organized and operated.

5.5. *Director Independence Under State Corporate Law.* A fundamental requirement in establishing a Special Committee is that its members be independent from the interested parties involved in the subject transaction, stockholder litigation or internal investigation, as the case may be. Absent that fact, the work of the committee will be vulnerable to attack regarding its objectivity and impartiality in dealing with the conflicted parties. Below is a discussion of key factors that should be taken into account in establishing the independence of a Special Committee under Delaware corporate laws. While this discussion is also helpful in considering independence under Texas corporate law, the TBCA, in keeping with the Model Business Corporation Act, provides in Article 1.02(12) and (15) definitions of "disinterestedness" and "independent" respectively, as discussed more fully in Section 5.2B above.

A. *Determining Independence.* The question of "independence" is a fact intensive issue which must be decided on a case by case basis. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1993). However, generally speaking, a director will be deemed to be disinterested if such director "neither appear[s] on both sides of a transaction nor expect[s] to derive any benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all

of its stockholders.” *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Furthermore, “independence” means that a director is “not dominated or otherwise controlled by an individual or entity interested in the subject transaction.” *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988). The burden of proof with respect to the issue of a director’s independence rests upon the party challenging the transaction. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1989).

- B. *Materiality of Self-Interests.*** Since independence is critical to the credibility of a special committee, selecting only the most pristine directors is the best practice to follow when a board establishes the committee. However, some boards may find that all of its directors have varying degrees of existing or prior business or close social relationships with the conflicted parties. Under these circumstances, the selection of committee members will necessarily include some directors that have some benefit flowing from the challenged transaction or some relationship with the interested parties. Even so, such a committee member may still be deemed to be independent for the purposes of representing the interests of the corporation and its disinterested stockholders. In that regard, in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), the Delaware Supreme Court observed:

“We have generally defined a director as being independent only when the director’s decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations . . . By contrast, a director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent.” 634 A.2d at 361 (emphasis added).

Based upon the foregoing, the Delaware courts have concluded that a benefit must be material to a committee member before it will cause that member to be viewed as not being independent. For instance, in *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489 (Del. Ch. 1996), one member of a two-member committee had a consulting agreement with the corporation. The court recognized that because the continuation of that arrangement depended upon the goodwill of the conflicted directors, the independence of the member was subject to challenge. But, in doing so, the court said that his independence must turn on whether the value of the consulting agreement was “so de minimus that it could not have influenced [his] ability to consider the [challenged transaction] impartially.” (emphasis added) *Id.*

In the case where there are no “independent” directors, one alternative is to appoint additional directors to the board who are independent and who will constitute the special committee. See *Carlton Investments v. TLC Beatrice International Holdings, Inc.*, C.A. No. 17950 (Del. Ch. 1997) (two independent directors added to a board of directors to act as special committee).

- C. *Effect of Material Benefits from Prior Relationships With Conflicted Parties.*** In reviewing the conduct of a special committee, the court in *Kahn v. Tremont Corp.*, 694 A.2d 422, 426 (Del. 1997) strongly criticized the prior business relationships that several committee members had with the controlling stockholder. Likewise, in *In re MAXXAM, Inc., Shareholders Litig.*, C.A. No. 12111 (Del. Ch. 1997), the court found that a special committee had not shifted the burden of proof in part because all of its members had significant financial and business relationships with the conflicted parties.
- D. *Non-disqualifying Benefits.*** The Delaware courts have recognized that a director's receipt of customary director fees or the receipt of pension benefits, standing alone, will not constitute a disqualifying financial interest (see *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) and *Parnes v. Bally Entertainment Corp.*, C.A. No. 15192, slip op. (Del. Ch. 1997)) and a director's right to indemnification from the corporation will not be a disqualifying interest (*In Re Sea Land Corp. Shareholders Litig.*, 642 A.2d 792 (Del. Ch. 1992)). However, in the recent case of *In re Auto Credit, Inc. Shareholder's Litigation*, C.A. No. 19028 – NC (Del. Ch. January 10, 2003), the court of chancery held that director fees and other benefits can constitute a disqualifying financial interest under some circumstances when they are "shown to exceed materially what is commonly understood and accepted to be a usual and customary director's fee."
- E. *Effect of a Committee Member Not Being Found to be Independent.*** What is the impact if, in a subsequent legal challenge, some committee members are found by a court not to have been independent? In the *Kahn v. Dairy Mart Convenience Stores, Inc.* case, the Chancery Court downplayed the significance of having found that only one of the two committee members was independent in carrying out the functions of the special committee. The court said: "While that fact, standing alone, is not fatal to the defendant's position, it does call for careful judicial scrutiny. As [another Chancellor has noted] 'if a single member committee is to be used, the member should, like Caesar's wife, be above reproach.' *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985)." *Kahn v. Dairy Mart Convenience Stores, Inc.* C.A. No. 12489, slip op. In a similar vein, the chancery court in *In Re MAXXAM Shareholders Litig.*, 659 A.2d 260 (Del. Ch. 1995) indicated that a committee of five would continue to be viable if at least three members were found to be independent. In sum, it appears that the courts will not find that a lack of independence on the part of one or more committee members will in some way taint the independence of the remaining committee members so long as a majority continues to be independent.
- F. *One Person Committee.*** While appearance-wise it may not be desirable, a one person committee has found acceptance by the Delaware Courts. See *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985). And, as noted above, the court in *Kahn v. Dairy Mart Convenience Stores, Inc.* indicated that the lack of independence of one member of a two-person committee would not be fatal in itself.

G. *Effect of Social Relationships With Interested Parties.* In *In Re Oracle Corporation Derivative Litigation* 824 A.2d 917 (Del. Ch. 2003), Chancellor Leo Strine of the Delaware Chancery Court ruled that when questioning the independence of the members of a special litigation committee, social relationships between directors and interested parties should be taken into account. Before *Oracle*, in looking at director's independence, Delaware courts generally limited their inquiry to the presence of a material financial interest in the subject matter or dominance or control by the interested parties. Although noting the extensive nature and length of the investigation by the SLC of Oracle and its report, Chancellor Strine found that the two member committee (both tenured faculty members of Stanford University) failed to demonstrate independence due to the defendant-directors' financial and personal ties to Stanford University including the fact that one insider director as well as the company were significant donors to Stanford. The court concluded that "... by any measure, this was a social atmosphere painted in too much Stanford Cardinal red for the [SLC] members to have reasonably ignored." Likewise, the Chancery court in *In re eBay, Inc. Shareholders Litigation*, C.A.19988-NC, 2004 Del. Ch. Lexis 4 (Del. Ch. February 11, 2004) ruled that four outside directors were not independent because of their ties to interested directors. Because the interested directors owned voting control of the company, the court concluded that the four directors could not be impartial — they were beholden to the interested directors for the continuation of their board seats.

Subsequently, the Delaware Supreme Court in *Beam v. Stewart*, 845 A2d 1040 (Del. 2004) reaffirmed that friendship and social relationships, without more, do not jeopardize a director's independence. In looking at the facts surrounding the alleged insider trading by Martha Stewart, the court stated that "allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relations before joining the board and described each other as friends, even coupled with Stewart's 94% voting power are insufficient, without more, to rebut the presumption of independence." The court went out of its way to limit the holdings of *Oracle* and *eBay*.

The court explained that because of the serious liability risk a director would take in showing partiality toward an interested party, a plaintiff-stockholder would need to show that the challenged relationships were sufficient to take that risk.

6. BASIC LEGAL ADVICE FOR INDEPENDENT DIRECTORS IN THE POST-ENRON ERA

6.1. *Overview.* Representing independent directors, individually or as members of a board committee, has its challenges for independent legal counsel. To begin with, more often than not, independent directors come to outside legal counsel when they are under great stress and pressure. Their problem may stem from having to make a major business decision that involves difficult risks and legal exposure for them personally. On the other hand, independent directors can be put in the "hot seat" when a company receives a subpoena from the U.S. Justice Department, an

investigatory inquiry from the SEC Enforcement Branch or an offer from a controlling stockholder to take the company private. In any case, it is incumbent on legal counsel to bring calmness and confidence to the independent directors as they go about handling the problem/issues at hand. The bedside manner of legal counsel and his or her ability to prepare independent directors for dealing with the issue is key. Educating them at the beginning of the representation about what lies ahead is an absolute necessity. Legal counsel must advise them carefully about such things as what is expected of them under their fiduciary duties, what will be the tough issues that they can expect to face, what pitfalls they need to be on the lookout along the way, and what they can expect the end-game to be. Also, legal counsel needs to advise them up front on how they should deal with the interested parties during the process and how they should go about selecting and relying on third-party advisors including independent legal counsel. Having said that, independent legal counsel are also periodically called on by prospective directors to advise them about whether to accept a board position and by existing independent directors about what they need to do in fulfilling their federal and state fiduciary responsibilities as they serve on board committees and as part of the full board. Set forth below are some of the basic issues on which independent directors often seek advice.

- 6.2. *Conduct Due Diligence Before Deciding to Accept a Position on a Board of Directors.*** Before accepting a board seat, it is prudent that a would-be director diligently investigate, along with the help of legal counsel where appropriate, the company and its management and board of directors. Attached hereto as Appendix E is a checklist of items that a prospective director should consider in conducting due diligence. Without doubt, finding out about problems after joining a board can be very problematic for an independent director. Indeed, getting off a board can be a very difficult thing to do. Also, prospective directors should be very careful in completing director questionnaires and in preparing their resumes when being considered for a directorship. An embellished resume can be a nightmare if the director's competency and qualifications are later challenged in litigation.
- 6.3. *Recognize That Your Special Expertise Can Be A Factor In How Your Conduct as a Director is Judged.*** In the past, the Delaware courts (e.g. *Smith v. Van Gorkam*, 488 A2d 858 (Del. 1985)) generally took the position that director liability should be determined by looking at the board as a whole. More recently, the courts have taken a different approach by determining liability on a director-by-director basis. In *In re Emerging Communications Inc.*, 2004 Del. Ch. LEXIS 70 (Del. Ch. May, 2004) a board's approval of a merger was challenged on the grounds that the merger was unfair to the stockholders. In finding one director personally liable, the court distinguished him from the other directors based on his expertise. The court observed that he had "specialized financial expertise" that put him in a position that he "knew or, at the very least, had strong reasons to believe" that the merger price was unfair. Likewise, in *In re Walt Disney Co. Derivative Litigation*, 2005 Del. Ch. LEXIS 113 (August 9, 2005), the court of chancery also took the approach of carefully judging the directors on a one-by-one basis.

SOA §407 and related Item 401(h) of SEC Regulation S-K require that a public company disclose whether at least one of the members of its audit committee is a “audit committee financial expert”, as defined in 401(h)(2) and to publicly identify such person. Corporate lawyers have always questioned whether an “audit committee financial expert” would be held to a higher standard of care than his or her fellow directors notwithstanding that the SOA contains a safe harbor provision aimed at keeping that result from happening. After all, it would seem that with respect to the duty of care, the conduct (analysis, inquiries and view points) of a director with special expertise relating to a business decision being considered by a board would be expected to be different from that of the other directors without that expertise. In sum, a director should be mindful that a judge or jury will likely expect her or him to exercise greater care when considering issues pertaining to the director’s expertise in deciding culpability.

- 6.4. *Effectively Use Your Executive Sessions.*** Executive sessions are intended to encourage independent directors to discuss matters that they might be reluctant to discuss in the presence of management. These kinds of matters can range from terminating the CEO to concerns about the reliability of information that the board has been receiving from management. Since no member of management is there to do it, independent directors often neglect to keep brief minutes of what issues were discussed in executive session and who was present. If later challenged, having a written record of what was discussed can be helpful. Independent directors should also be careful to not allow executive sessions to take the place of full board meetings. If a consensus on a matter is reached in an executive session, the discussion and deliberation should be moved to the full board meeting. After all, directors do not technically have the authority to take action in an executive session. Moreover, where there is a full board present, appropriate board minutes are kept to show the reasonableness of the decision-making process.
- 6.5. *Make Your Board Meeting Minutes Count.*** Without doubt, board minutes can carry great weight in the mind of a jury or a judge in litigation challenging director conduct. In *in re Walt Disney Litigation*, 2005 Del. Ch. LEXIS 113 (August 9, 2005), the court carefully examined the minutes of board meetings and compensation committee meetings in determining board conduct and the board’s decision making process. Similarly, in *OmniCare v. NCS Health Care Inc.*, 818 A.2d 914 (2003) the court focused on board minutes in judging director conduct. While at one time, it was the common practice to prepare board minutes in a very abbreviated fashion, it is now clear that minutes should be thorough enough to adequately reflect the directors’ decision-making process. The objective, especially where a matter is expected to be legally challenged, is to have the minutes paint a clear picture of how hard the directors worked to do what was right in fulfilling their fiduciary responsibilities. While minutes do not need to reflect every question raised in a board meeting nor the details of the board’s deliberations, minutes should still evidence the director’s efforts to first become fully informed, to carefully deliberate the issues and then to exercise their independent judgment in making a decision.

It is also advisable to prepare and finalize board meeting minutes as quickly as possible after a board meeting where the substance of the meeting may likely be legally challenged. Tactically, it is important to do this while memories of the board members are still fresh and before any litigation has begun. Legal counsel should carefully walk the board through those parts of drafted minutes that would likely be focused on in litigation. Under some circumstances, it may be appropriate to indicate the start time and the ending time of the meeting to show the serious consideration that was given to the matter. In fact, in *In re Walt Disney Co. Litigation*, 2005 Del. Ch. LEXIS 113 (August 9, 2005), the court made special note of the fact that the compensation committee met less than an hour in considering the employment agreement of a key executive.

- 6.6. *Be Prudent in Taking Personal Notes for a Board Meeting.*** Personal notes taken at, or in preparation for, a board of directors meeting can be very problematic for a director. If notes are taken, a personal sensitivity to clarity in writing is essential to avoid the pitfalls of confusing words and phrases. Notes are typically very ambiguous and thus, subject to being miscast by a plaintiff's lawyer to serve his purposes. For that reason, some directors adopt a personal policy that once board minutes are finalized and approved to his or her satisfaction, the related notes can be disposed of since they are no longer needed. Of course, if the minutes do not reflect what occurred, the director has a good reason to keep his or her notes. By the way, it should also be remembered that emails and memos sent by directors to other directors and management are discoverable as well in litigation and government investigations. Finally, in the case of government investigations, board members need to be cautioned about obstruction of justice issues with respect to the disposal of personal notes, etc. Clients need to be warned against turning a non-problem into a criminal problem.
- 6.7. *Exercise Special Care When Relying on the Reports of Management, Board Committees and Third Party Experts.*** Many defendant-directors in stockholder derivative or securities fraud cases have based their defense on the grounds that in taking the challenged corporate action, they had relied on the advice, reports or statements of board committees, accountants, lawyers, corporate executives or other third-party experts. Section 141(e) of the DGCL and Article 2.41C of the TBCA provide that a director is "fully protected" when he or she relies in "good faith" on such third-parties. The key thing for independent directors in establishing reasonable reliance is (i) to make due inquiry to the qualifications and independence of the expert and (ii) to challenge the assumptions, analysis and other methods used by the expert in reaching its conclusions. Directors, who have specialized expertise in a particular area for which a board utilizes a recognized expert, need to exercise special care in deciding whether the expert is qualified and its reports are reliable. See the discussion in Section 6.2 above. These directors must be able to demonstrate to a judge or jury that their reliance was "reasonable" given their own expertise. Most importantly, if there is sufficient doubt about an expert's conclusion or work, directors should not hesitate to ask for a second opinion.

6.8. Diligently Follow a Sound Decision-Making Process. The following steps should be in the forefront of a director’s mind as he or she strives to satisfy the director’s duty of care, especially the obligation of “good faith” conduct. The key thing for a director to remember is that the courts are going to largely focus on whether the board followed a reasonable decision-making process in determining culpability under the business judgment rule and the standard of “good faith” conduct. If directors work diligently to “do the right thing” in carrying out their fiduciary duties, “good faith” conduct should never be at issue.

First – Dedicate sufficient time toward reaching a decision.

- Do not be “stampeded”
- Hold appropriate/multiple meetings (face-to-face v. telephonic)
- Allow sufficient time for directors to absorb information
- Insist that you be given adequate notice and time under the circumstances to prepare for each board meeting.

Second – Become fully informed before making a decision.

- Insist on receiving information in advance of meetings
- Do homework before meetings
- Probe, probe, probe for pertinent information
- Insist on receiving appropriate reports and advice from management, board committees and third-party experts (e.g. legal counsel)
- Diligently evaluate and analyze information provided by management and third-party experts with a healthy dose of skepticism
- Establish facts that show Board reasonably relied on management, board committees and third-party experts by appropriately inquiring about their expertise, knowledge, objectivity and preparations and by appropriately challenging their, assumptions, methodology, projections, and conclusions

Third – Carefully deliberate the issues among the directors before making a decision.

- Attend meetings
- Sufficient back-and-forth debate and analysis of issues
- Identify “soft spots” and seek additional information

Fourth – Exercise independent business judgment in making a decision.

- Do not be a “rubber stamp” to management

- Think and act independently
- Be prepared to say “no” to management if that is the directors’ decision
- Meet in executive session about the issue to be decided where appropriate

Fifth – Prepare board minutes that adequately reflect how the board adhered to the above steps in its decision-making process.

- See Section 6.5 above.

6.9. *Adhere to the Duties Spelled Out in Your Committee Charters.* Board committees must never fail to satisfy the requirements imposed on them by their committee charters. Moreover, an annual evaluation of the provisions of the charter is imperative so that the committee can satisfy itself that the charter properly reflects what it does.

6.10. *Start Your Special Transaction Committee Right From Day One.* Typical mistakes made in establishing special transaction committees is the failure by the board to properly determine the independence of its members and to adequately spell out the committee’s charge in a board resolution. Moreover, the special committee process can often be tainted by members of management by getting involved in the selection of independent legal counsel and other independent advisors. The special committee must think and act as if it is a stand-alone “board” that operates totally arm’s-length from the conflicted parties. After independent legal counsel has been selected, the first step should be to spend adequate time (even if it requires a full day or more) briefing the committee on its fiduciary duties, the issues and problems at hand and what the directors should expect as they carryout their fiduciary responsibilities. See Section 6.1 above.

7. CONCLUSION.

**OUTLINE OF A TYPICAL AUDIT COMMITTEE CHARTER REFLECTING THE
BROAD RESPONSIBILITIES OF INDEPENDENT DIRECTORS**

1. *Statement Of Purpose.*

- (i) Oversee the integrity of financial statements and disclosures.
- (ii) Oversee compliance with legal and regulatory requirements.
- (iii) Oversee the qualifications and independence of external auditor.
- (iv) Oversee the internal audit function.

2. *Membership Composition.*

- (i) Number of members (including minimum number).
- (ii) Qualifications:
 - “Independence” requirement
 - “Audit Committee Financial Expert” requirements
 - “Financial Literacy” requirements
- (iii) Manner of appointment.
- (iv) Term of office.
- (v) Compensation restrictions.

3. *Authority.*

- (i) Right to retain independent advisors.
- (ii) Right to pursue educational programs.
- (iii) Right to conduct independent investigations.
- (iv) Right to full access to employees and corporation information.

4. *Meetings.*

- (i) Frequency.

- (ii) Executive sessions with key personnel and agents.
- (iii) Keeping minutes.
- (iv) Quorum requirement.
- (v) Agenda preparation.
- (vi) Presiding director.

5. *External Auditor Oversight.*

- (i) Sole authority to select, retain, oversee, terminate, and evaluate the external auditor.
- (ii) Process for pre-approving audit and non-audit services of the external auditor.
- (iii) Process for assessing independence and qualifications of the external auditor.
- (iv) Process for assessing the internal quality controls of the external auditor.
- (v) Confirmation from the external auditor of required audit partner rotation.

6. *Internal Auditing Function Oversight.*

- (i) Performance evaluation of internal audit staff.
- (ii) Process for planning and coordinating the company's internal audit program.
- (iii) Process for reviewing reports of the internal audit staff to management.

7. *Financial Statements And Disclosure Oversight.*

- (i) Process for reviewing, prior to filing, all 10-Qs and 10-Ks and the procedures for issuing earnings releases and guidance.
- (ii) Process for reviewing and approving, before their implementation, all significant accounting changes.
- (iii) Process for periodically assessing the adequacy of the company's financial disclosures.
- (iv) Process for monitoring third-party criticisms of the company's financial statements and disclosures and for receiving and handling whistle-blower complaints.

8. *Internal Controls And Legal Compliance Oversight.*

- (i) Process for periodically (x) assessing the adequacy and effectiveness of internal control systems and policies on compliance with laws and regulations and (y) reviewing the internal controls evaluation and any reports of fraud made by the CEO and CFO in their SEC certifications pursuant to SOA §302.
- (ii) Process for monitoring adequacy of information security systems.
- (iii) Process for monitoring allegations of misconduct by officers or directors.
- (iv) Process for monitoring any significant disagreements with outside legal counsel regarding public disclosures or other legal compliance issues.

9. Risk Management Oversight.

- (i) Process for periodically reviewing major risk exposures and for assessing steps taken to monitor and control such risks.
- (ii) Process for periodically assessing insurance coverage.
- (iii) Process for periodically assessing all special-purpose entities, off-balance sheet transactions, commodity contracts with no quoted market price and related party transactions.
- (iv) Process for periodically receiving reports from legal counsel regarding significant unasserted and asserted legal claims and other risk management issues.

10. Making Reports And Assessments.

- (i) Process for periodically reporting activities of the audit committee to the board of directors.
- (ii) Process for annually conducting an assessment of the audit committee charter.
- (iii) Process for conducting the annual self-assessment of the audit committee's performance.
- (iv) Process for preparing the audit committee report to be included in the company's proxy statement for its annual meeting.
- (v) Process for recommending action to the board of directors regarding the inclusion of the financial statements in the company's Form 10-K.
- (vi) Process for ensuring board of directors access to external auditor.

11. General Duties.

- (i) Responsibility of management and the external auditor for the financial statements.

- (ii) Charter provisions serve as general guidelines for the audit committee in carrying out its oversight functions.

**OUTLINE OF A TYPICAL NOMINATING/GOVERNANCE COMMITTEE
CHARTER REFLECTING THE BROAD RESPONSIBILITIES OF
INDEPENDENT DIRECTORS**

1. *Statement Of Purpose.*

- (i) Identify individuals qualified to become board members.
- (ii) Make recommendations to the Board regarding the nominees for director.
- (iii) Develop and recommend to the Board the company's corporate governance policy.
- (iv) Take a leadership role in shaping the company's corporate governance.
- (v) Review and make recommendations regarding the company's policies related to public and social issues.

2. *Membership Composition.*

- (i) Number of members (including minimum number).
- (ii) Qualification.
- (iii) Manner of appointment.
- (iv) Term of office.

3. *Meetings.*

- (i) Frequency.
- (ii) Keeping minutes.
- (iii) Quorum requirement.
- (iv) Action by unanimous written consent.

4. *Board And Committee Matters.*

- (i) Establish nominee criteria and qualifications.
- (ii) Search for and identify a pool of candidates.
- (iii) Right to retain a search firm in the committee's sole discretion.
- (iv) Recommend to Board a slate of nominees for election or reelection.

- (v) Evaluate company's director recruitment policy.
- (vi) Review and make recommendations to Board regarding Board compensation and structure.
- (vii) Review and make recommendations to Board regarding nature and duties of board's committees.
- (viii) Develop and oversee a director orientation and continuing education program.
- (ix) Delegate authority and responsibilities to subcommittees as deemed proper.

5. *Executive Officer Matters.*

- (i) Receive recommendations from the CEO regarding management succession.
- (ii) Recommend to the Board a successor to the CEO when a vacancy occurs.
- (iii) Recommend and review any personnel changes involving SEC reporting officers.

6. *Corporate Governance Oversight.*

- (i) Review the company's policies and programs in such areas as:
 - Code of ethics;
 - Charitable contributions; and
 - Director orientation and continuing education.
- (ii) Meet or communicate with company constituents.

7. *Reports And Assessments.*

- (i) Report from time to time to Board on Committee actions and fulfillment of Committee's responsibilities.
- (ii) Make annual review and self-assessment of performance.
- (iii) Develop and oversee and annual assessment of the full Board.

**OUTLINE OF A TYPICAL COMPENSATION COMMITTEE CHARTER
REFLECTING THE BROAD RESPONSIBILITIES OF
INDEPENDENT DIRECTORS**

1. *Statement Of Purpose.*

- (i) Assist Board in its responsibility relating to fair and competitive compensation of key company employees.
- (ii) Assure that key employees (which should include at least the company's SEC reporting officers) are compensated in a manner consistent with the compensation philosophy and strategy of the Board and in compliance with the requirements of regulatory bodies.
- (iii) Review and approve the company's compensation philosophy and its compensation programs, plans, and awards.
- (iv) Administer company's long and short term incentive plans and other stock-based plans.
- (v) Review and approve company's general employee pension benefit plan and other benefit plans as needed.

2. *Membership Composition.*

- (i) Number of members (including minimum number).
- (ii) Qualifications.
- (iii) Manner of appointment.
- (iv) Term of office.

3. *Meetings.*

- (i) Frequency.
- (ii) Keeping minutes.
- (iii) Quorum requirement.
- (iv) Action by unanimous written consent.

4. *General Compensation Oversight.*

- (i) Review company's executive compensation strategy and philosophy and consult with CEO regarding strategy's effect on achievement of company goals.
- (ii) Assure that total compensation paid to key employees is appropriate and consistent with company's compensation philosophy.
- (iii) Annually review market and industry data to assess company's competitive position with respect to compensation.
- (iv) Right to retain a compensation consultant in Committee's sole discretion.
- (v) Administer company's incentive compensation or option plan and stock related plans through:
 - approving option guidelines and size of grants;
 - making grants;
 - interpreting the plans;
 - determining the rules and regulations relating to the plans;
 - modifying or canceling existing grants and substituting new grants (with the consent of the grantees);
 - designating employees eligible to participate in the plans; and
 - imposing limitations, restrictions, and conditions upon any award as permitted under the applicable plan.
- (vi) Monitor the proposed awards for conformance with any restrictions placed thereon by the Board and the shareholders and advise Board if any conflict exists.
- (vii) Review with the CEO matters related to management succession.
- (viii) Periodically review and make recommendations to the Board regarding the company's stock ownership guidelines.
- (ix) Delegate authority and responsibilities to subcommittees and deemed proper.

5. *Non-CEO Compensation Oversight.*

- (i) Review with the CEO the CEO's recommendations for the compensation of other key employees.
- (ii) Annually review and make recommendations to the Board regarding the compensation made to the company's key employees.

- (iii) Annually review and make recommendations to the Board regarding the benefits and prerequisites made to the company's key employees.
- (iv) Review and make recommendations to the Board regarding agreements proposed to be entered into with the company's key employees.
- (v) Review and make recommendations to the Board regarding any deferred compensation arrangement proposed to be entered into with the company's key employees.
- (vi) Review and make appropriate recommendations to the Board regarding the competitiveness and appropriateness of compensation paid to executive officers of subsidiaries.

6. *CEO Compensation Oversight.*

- (i) Annually review and approve the compensation made to the CEO considering the following variables:
 - company's performance during good and bad economic cycles;
 - relative shareholder returns;
 - value of incentive awards to CEOs at comparable companies;
 - proper balance between long and short term incentives;
 - differences in compensation at various levels of company management; and
 - achievement of the corporate goals and objectives that were reviewed and approved by the Committee the previous year.
- (ii) Annually review and make recommendations to the Board regarding the benefits and prerequisites offered to the CEO.
- (iii) Review and make recommendations to the Board regarding agreements proposed to be entered into with the CEO.
- (iv) Review and make recommendations to the Board regarding any deferred compensation arrangement proposed to be entered into with the CEO.
- (v) Approve in advance any salary adjustment for CEO and explain such adjustment in writing to the Board.

7. *Director Compensation Oversight.*

- (i) Annually review and make recommendations to the Board regarding the compensation made to the company's directors.

- (ii) Monitor the amount of compensation proposed to be paid to any director, and its effect on director independence, for compliance with the company's equity compensation plans.

8. *Reports And Assessments.*

- (i) Report from time to time to Board on Committee actions and fulfillment of Committee's responsibilities.
- (ii) Make annual review and self-assessment of performance.
- (iii) Issue an annual report to Board regarding the propriety of the compensation arrangements and whether the compensation arrangements met their stated purpose and served the interests of the company.
- (iv) Prepare an annual report as required by SEC rules and regulations and submit it to the Board for inclusion in the company's proxy statement.

**OUTLINE OF TYPICAL CORPORATE GOVERNANCE GUIDELINES REFLECTING
THE BROAD RESPONSIBILITIES OF INDEPENDENT DIRECTORS**

(1) *Board Composition And Performance.*

Director Qualification Standards. The qualifications for serving on a board of directors is the most basic governance policy to be included in the governing principles. Of course, the regulatory mandates regarding director “independence” (e.g. NYSE Proposed Rules 303A(1) and (2) and NASDAQ Proposed Rule discussed in Section 2.3 below) are the starting point for inclusion in a company’s qualification standards for directors.

Observation: Other kinds of director qualifications that companies often include in their governance guidelines are the following:

- (i) *limitation on term of service;*
- (ii) *age limitation on standing for re-election (e.g. 75 years);*
- (iii) *limitation on the number of other public-company boards that a director can serve on;*
- (iv) *limitation on serving on the audit committee of other public company boards;
and*
- (v) *resignation requirement in case of change of personal circumstances (e.g. change in principal work responsibility);*
- (vi) *ability to devote time required for board service;*
- (vii) *required stock ownership in the company.*

Size Of Board. Usually the number of board members is indicated by range (e.g. 10-15).

- (2) *Director Responsibilities.*** Governance guidelines typically set forth the basic responsibilities of directors in very general terms such as: “*The board’s purpose is to build long-term value for the stockholders. The business of the company is to be managed by its officers under the oversight of the board. The board’s primary functions are to oversee management’s development of sound business plans and strategies, to select the chief executive officers and other senior officers, oversee management succession planning and ensure the company adheres to the highest standards of ethical conduct and complies with applicable laws and regulations.*”

(3) ***Board Operation and Structure.***

- Compensation
- Meetings
- Executive Sessions
- Performance Review
- Agenda Preparation
- Board Packages
- Frequency
- Selection of Chairman

(4) ***Board Committees.***

- Selection
- Operations
- Responsibilities

(5) ***Selection of Director Nominees.***

- Criteria
- Process

(6) ***Director Orientation and Continuing Education.*** A company's policy toward providing continuing education to board members is generally covered in the guidelines. Certain companies, however, elect to provide specific and detailed guidelines in their committee charters. For example, Home Depot requires directors to periodically visit company stores, plants and other operating facilities.

(7) ***Management Succession.*** The guidelines should delineate how the board selects and reviews the chief executive officer and other key executive officers and its preparation and policies for management succession.

Annual Board Evaluations. The guidelines should set forth the procedures by which the board of directors will annually conduct a self-evaluation of its own performance. Some boards use formal written surveys in carrying out self-evaluations. There is usually great debate in boardrooms to using such an instrument. The fear of many is that a survey will be "Plaintiff's Exhibit 1" if litigation ensues.

PROSPECTIVE DIRECTOR'S DUE DILIGENCE CHECKLIST

The degree in which the items on this list are considered for due diligence will depend on the circumstances and risks identified initially and on other sources of information available for consideration.

Company Review

- Business/industry issues
- Financial stability issues (balance sheet/income statement, cash flow and liquidity, projections, capital expenditure budget, etc.)
- Customer/supplier issues
- Risk management issues
- Business strategy and long-term planning issues
- Legal compliance issues
- Financial statements/accounting issues
- Reputation

Company Document Review

- Annual Report to Shareholders
- SEC Filings (10-K, 10-Q, 8ks, Proxy Statements)
- Organizational Chart
- Long-Term Plan/Projections
- Corporate Charter/Bylaws
- Code of Conduct
- Board Committee Charters
- Governance Principles
- Legal Compliance Programs
- Whistle-Blower Procedures

- Lawyer Response Letters to Auditors
- Board Self-evaluations
- Employment Agreements with key executives officers
- Shareholder/investment analysts' complaints

Management Team Issues

- Reputation
- Experience
- Management style/philosophy
- Interaction/communication with board
- Board evaluations of management team

Board of Director Issues

- Structure/operating philosophy
- Chairman/Lead Director
- Number of directors
- Board committees
- Quality/competency/expertise/reputation of directors
- Flow of information to board
- Director stock ownership requirements
- Director compensation
- Time commitment required
- Board expectations for prospective director
 - Time
 - Expertise/experience
 - Committee assignments

- Diversity of board
- Culture/philosophy of board in working together and with management

Personal Interviews (in-person or by phone)

- Lead Director/Chairman
- Other directors as appropriate
- CEO and other members of management team as appropriate
- General counsel
- Chief Compliance Officer (if there is one)
- Audit partner as appropriate
- Appropriate Third Parties to confirm reputations, etc.
- Compensation Consultant to the Compensation Committee

Director Liability Protection Issues

- D&O Insurance Policy Review
- Corporate charter/Bylaws Indemnification Provisions Review
- Indemnification Contract
- Corporate Charter Exculpatory Provision
- Insider Trading Policies

Personal Questions

- Do I have time?
- Am I “independent”?
- Can I contribute to board?
- Does this board position create any conflicts?
- Would this adversely affect other long-term goals of mine?