

Legal Trends in Corporate Governance

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Sources of Corporate Governance Initiatives

- In response to scandals of the “bubble” period, Congress, SEC, NYSE, NASDAQ and state courts have established requirements for conduct of corporate affairs.
- Result: Federalization of corporate governance – a “One size fits all” approach
 - Sarbanes-Oxley Act of 2002
 - NYSE Corporate Governance Rules
 - NASDAQ Corporate Governance Rules
 - SEC/Open Access for director nominations
 - State law (struggling for relevance in response to federalization of requirements for corporate conduct)
- Shareholder activists are and will continue to be catalysts for governance initiatives

Corporate Governance: Sarbanes-Oxley Act

Corporate Governance

- Audit committee (independence and “financial expert”)
- Code of ethics
- No insider trading in pension blackouts
- Attorney conduct
- Corporate loans to officers
- Improper influence on auditors
- No retaliation for whistleblowing

Auditors

- PCAOB
- Independence (non-audit services, 5-year rotation, prior employment and compensation)
- Workpaper retention

Enhanced Disclosure

- CEO/CFO certification
- “Fairly presents” standard
- Disclosure controls and procedures and internal controls
- Off-balance sheet arrangements
- Non-GAAP financial measures
- CEO/CFO disgorgement following restatement involving “misconduct”
- Accelerate beneficial ownership reporting
- Earnings releases on Form 8-K
- Website posting of Exchange Act reports
- Report material adjustments to financials
- Real time disclosure
- Systematic SEC review of disclosure

Audit Committee Requirements

Audit Committee has become a key corporate governance gatekeeper

- Company must disclose in its annual report:
 - the determination of the Board that the company either has at least one “audit committee financial expert” on its audit committee (and his or her identity), or not (and if not, why not); and
 - whether each named audit committee financial expert, if any, is “independent” from management
- Auditors must report directly to the audit committee, which has responsibility for appointment, compensation and oversight of auditors (including resolving disagreements)

Audit Committee Requirements (cont'd)

- All audit committee members must be independent (e.g., no fees except director and committee fees and cannot be an “affiliated” person of the issuer)
- Audit committee to establish procedures for receiving complaints and anonymous employee tips concerning accounting, internal controls or auditing matters
- Audit committee can engage own advisors and has own funding for paying auditors and its advisors

Corporate Governance: New NYSE Rules

- Enhanced definition of director independence
- Board must consist of a majority of independent directors
- Regularly convened executive sessions of independent directors
- Require companies to establish compensation & nominating/corporate governance committees composed entirely of independent directors
- Require corporate governance guidelines be adopted and disclosed
- Require a code of business conduct and ethics for all directors, officers and employees, which must be publicly available. Waivers to the code for executive officers and directors can only be granted by the Board, and must be promptly disclosed
- Shareholder approval of all stock option plans and material modifications to existing stock option plans
- CEOs must annually certify compliance with listing standards

Initiatives by Securities and Exchange Commission

Historically sought to use disclosure provisions to modify conduct; open access would go much farther

- Adopted new rules on nominating committee and shareholder communications disclosure
- Shareholder access to nominating process (proposed)
 - Access to be triggered by (1) 35% withhold vote for any company nominee or (2) majority vote in favor of opt-in proposal
 - Limitations: nominations by 5% holder which is 13G eligible; nominee must be independent; numerical limits, depending on Board size
 - Adoption will result in more partial proxy fights; impact on staggered boards

State Law/Directors' Duties

Primary source of corporate governance requirements before Congress, SEC and NYSE/NASDAQ became involved in recent years

- The basic responsibility of directors is to exercise their business judgment to act in a manner they reasonably believe to be in the best interests of the company and its shareholders
- Directors are entitled to rely on management and the advice of outside advisors and auditors; however, directors must take care to establish that they have a reasonable basis for such reliance
- Directors are expected to attend board and committee meetings and to spend the time needed to properly discharge their functions
- Directors should make sure they receive from management and outside auditors and advisors all the information and data they deem relevant to understanding the issues before them and reaching sound business judgments with respect thereto

BUT: are directors to blame when matters go wrong?

- Abbott Laboratories
- Caremark

Shareholder Activism

- Under the rubric of “corporate governance” shareholder activists push very hard to eliminate takeover defenses and make other changes they regard as desirable
- Record number of shareholder proposals in 2003 – first “1K” season (over 1,100 proposals)
 - Record number (166) achieved majority shareholder support
 - 50% more governance proposals than in 2002
 - Executive compensation the leading topic for the first time
 - Other “hot button” issues for activist shareholders: staggered board; poison pill; separate Chairman of the Board and CEO positions; pharmaceutical industry-specific proposals
- Standardization of shareholder voting in lieu of case-by-case analysis
 - Power of proxy advisors
- Institutional Shareholder Services (ISS) developed the Corporate Governance Quotient (CGQ) for monitoring and comparing the corporate governance structures of America’s leading publicly-traded companies. Others entering governance rating “business”

Shareholder Activism (cont'd)

- ISS recommends withholding votes from Directors who:
 - ignored a shareholder proposal that was approved by a majority of the votes cast for two consecutive years or
 - ignored a shareholder proposal approved by a majority of the shares outstanding
- Council of Institutional Investors principles: “Boards should take actions recommended in shareholder proposals that receive a majority of votes cast (and, if shareholder approval is required for the action, the Board should submit the proposal to a vote at the next shareholder meeting)”
- ISS governance study: strong takeover defenses were positively correlated with strong corporate performance
- Shareholder proposals are nonbinding. However, if ignored, shareholders could withhold votes or seek to replace Board members at the next annual meeting

How to Respond

- Board conduct
- Business judgment rule is alive and well
- Collective action problem
- Impact of withhold vote campaigns
- How to tell company's story