508:Corporate Governance Practices: Corporate Perspective

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Faculty Biographies

Lydia I. Beebe

Lydia I. Beebe is corporate secretary of ChevronTexaco Corp. Previously, she served as corporate secretary of Chevron Corp.

Ms. Beebe is a member of the State Bar of California and the ABA. In addition, she served on the California Fair Employment and Housing Commission and was the organization's chairperson. Ms. Beebe is a member of the San Francisco Municipal Fiscal Advisory Committee to the mayor and serves on the boards of the Professional Business Women of California, the Seneca Network, Golden Gate University, and the American Society of Corporate Secretaries.

Ms. Beebe earned a bachelor's degree from the University of Kansas and a doctor of law degree from the university's school of law. She also obtained a master's degree in business administration from Golden Gate University in San Francisco.

James L. Gunderson

James L. Gunderson is corporate governance counsel of Schlumberger Limited, a global technology services company. He plays a similar role at Veeco Instruments Inc., a provider of equipment for manufacturers of nanoscale products in the global semiconductor, data storage, telecommunications, and scientific research industries, and at Actaris, a large, privately held producer of metering systems for the energy and water utility industries. Mr. Gunderson spent most of his career with Schlumberger, including three years as secretary and general counsel, and eight years managing the legal departments of several large wholly owned divisions.

Prior to joining Schlumberger, Mr. Gunderson was an associate in the corporate department of the firm of Mudge Rose Guthrie Alexander & Ferdon in New York, and a stagier at the firm of Nauta Van Haersolte in Amsterdam before that.

Mr. Gunderson is a director of the New York Chapter of the National Association of Corporate Directors, a member of the Advisory Board of Executive Health Exams International, and a Senior Advisor to Nestor Advisors, Ltd., a European corporate governance advisory firm. Mr. Gunderson is also an honorary lecturer on corporate governance and strategic transactions at the Centre for Energy, Petroleum and Mineral Law and Policy at the University of Dundee, Scotland, and an associate editor of the Oil, Gas and Energy Law Intelligence Service.

Mr. Gunderson received a BA from the University of California, Santa Cruz, and is a graduate of the University of California, Hastings College of the Law.

Michael J. Halloran

Michael J. Halloran is the former group executive vice president and general counsel for BankAmerica Corporation, in San Francisco. He served as chief worldwide legal officer for BankAmerica, managing over 450 employees (185 attorneys), and was adviser to the board and

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senior management. He was also a member of the Bank's senior management council. He served on the product review committee where he approved securities products, and served on the social policy committee. Mr. Halloran negotiated, closed, and implemented over 30 acquisitions, including some of the largest and most complex in the banking industry. He fostered the creation and/or significant expansion of securities operations, including investment banking, investment management, and retail broker dealer businesses.

Mr. Halloran founded and led Pillsbury Winthrop's Washington, DC, office. Among his many accomplishments in this position, Mr. Halloran created and operated its venture capital funds, was a participant with venture capitalists and/or management in several high technology start up ventures, and has served on the board of advisors of venture capital and buy-out funds and the boards of the resulting public companies.

Mr. Halloran was honored by the BTI Consulting Group with their "Client Service All-Star Award." In addition, Mr. Halloran was placed on the Global Counsel 3000 Recommended List in 2002. Mr. Halloran is the lead author and editor of *Venture Capital & Public Offering Negotiation.* He is the author of several articles on corporate governance, going public, securities offerings domestically and abroad, investment companies, dispositions of restricted securities, duties of directors, and corporate restructuring. Additionally, Mr. Halloran serves on the editorial advisory board of *The M&A Lawyer* and *The Corporate Accountability Report.* He is a member of the ABA's corporate laws committee, a board member and immediate past president of the board of trustees of Boalt Hall School of Law at University of California at Berkeley, and a member of the board of advisors of *Stanford Journal of Law, Business and Finance.*

Mr. Halloran received his BS and LLB from the University of California at Berkeley.

Luise M. Welby

Luise M. Welby is assistant general counsel at Freddie Mac in McLean, Virginia. She is a securities attorney currently specializing in matters related to disclosure, periodic reporting, and corporate governance. She also has an extensive background in strategic initiatives and technology transactions.

Prior to joining Freddie Mac, Ms. Welby worked at the Securities and Exchange Commission, and in her last position was counsel to Commissioner Steven M.H. Wallman. She began her career as a corporate and securities associate with Hogan and Hartson in Washington, DC.

Ms. Welby is vice chair of ACCA's Corporate and Securities Law Committee. She is also a member of the board of directors of The Arlington Community Temporary Shelter ("TACTS"), a nonprofit organization serving abused and homeless women and their families in Arlington, Virginia.

Ms. Welby received a BBA from the University of Notre Dame and a JD from the University of California at Los Angeles School of Law.

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Audit Committees and QLCCs

Presentation notes from 2 sections of the June 2003 NACD/ACCA program:
"What the Board Expects from the Secretary/General Counsel"

Has the focus of Sarbanes Oxley and the accompanying regulations on Audit Committees changed the potential liability of audit committee members? I don't see how one can increase the duties and obligations of the audit committee without increasing the potential liability of the members. In the SEC's commentary to its final rule regarding audit committee financial experts, they contrast that disclosure requirement under Section 407, which does not increase the duties, obligations or potential liability of the person designated as financial expert, with the Section 301 requirements on audit committees which we will be discussing for the next few minutes, which do impose substantive requirements and therefore clearly increase potential liability. So we need to fulfill our active support role by advising the board on those duties and ensure processes are appropriate.

The Responsibility of the Audit Committee

- Sarbanes Oxley Section 301:
  - Audit Committee directly responsible for the appointment, compensation and oversight of the work of any auditor (including resolution of disagreements with management)
  - Auditor shall report directly to the Audit Committee
- Most Audit Committee charters need to be revised to accommodate this change in responsibility
- Most Audit Committee practices need to be adjusted to ensure due fulfillment of the increased responsibility

Prior to Sarbanes Oxley, the Audit Committee reviewed management's appointment of the auditor, the board approved the choice and then the shareholders in turn approved the choice at the annual meeting. Today management can only give input, and must leave the primary responsibility for the choice to the Audit Committee. Does that mean the Audit Committee members have more to do to satisfy their duty of care? .

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I think they do. Mistakenly appointing an auditor that later proves to be not independent could deprive a company of independently audited accounts. The same thing could happen if the Audit Committee mistakenly approves the auditor providing prohibited services. Mistakenly appointing an auditor or audit team that does not have the specialized expertise to handle sophisticated issues that a particular company or industry may have could result in problems and ultimately restated earnings.

Audit Committee tasks have become so extensive and technical that committee evaluations and planning have become essential. The NYSE proposed listing standards would actually require annual performance evaluations.

Audit Committee Evaluation

- Review Objectives of the Audit Committee
  - Compare Charter with new legal requirements as well as new expectations of stockholders and regulatory authorities
  - Discuss the priorities appropriate for the Company
- Review Audit Committee Practices
  - Update Audit Committee Calendar to include new tasks
  - Adjust roles and practices of various players (outside auditors, management, internal auditors, etc.) to conform to rules
- Review Audit Committee Performance
  - Get input from Board, Committee members and support team
  - Discuss extent objectives are met effectively
  - Discuss extent processes are performed efficiently

Audit committee charters are readily available from Edgar filings, so I didn't see a need to include one. I do suggest that in looking at other company's audit committee charters that you note any differences between your company and the one you are looking at in terms of applicable corporation law. Some jurisdictions are more restrictive than others regarding delegation of powers from the board to a committee. For example in one case it might make sense to have the audit committee select the auditors, and in another it might make sense to have the audit committee select the candidate, and have the board submit the candidate to the shareholders for approval.

I would also recommend restraint in adding responsibilities to audit committee charters that go beyond what is required by law. Too much involvement in too many operational matters could jeopardize the committee's independence from management. Audit Committee members may not possess the necessary competence or have the time to perform ever expanding tasks.

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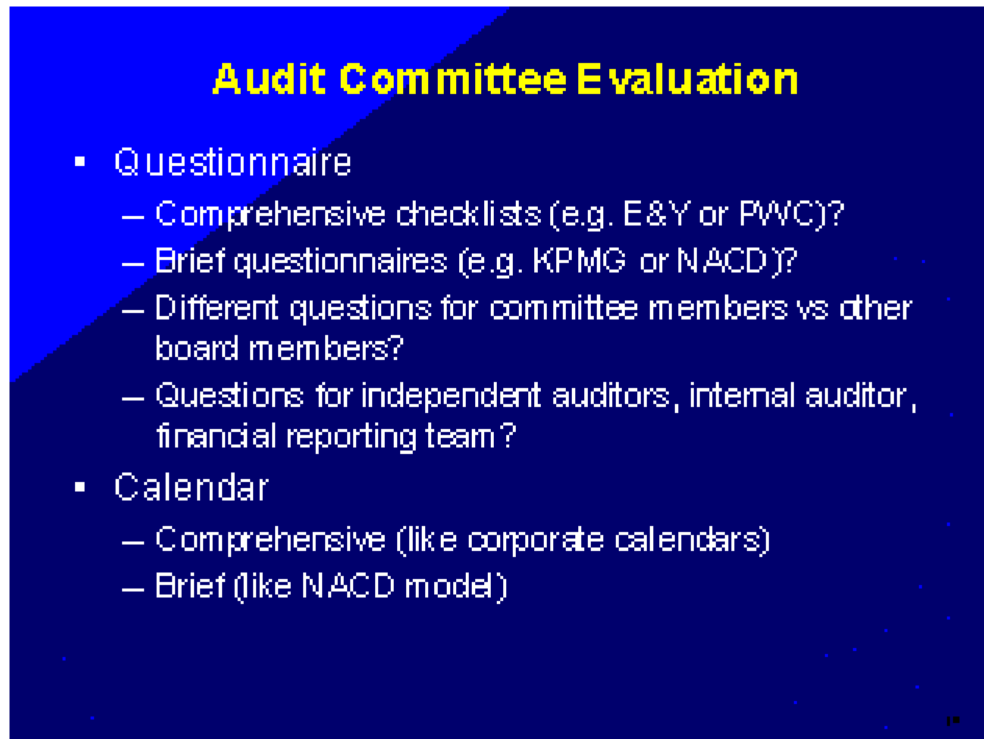
For the next few minutes I'd like to focus on the other two items for which you may not have as easy access to precedents and advice as you do for charters – lets look at evaluations and calendars.

The Audit Committee evaluation is a more legally driven exercise than a full board assessment. There is much more emphasis on making sure nothing important is being missed, and that everything is being done diligently and competently. Therefore it is more important to get input from above (the full board) and below (the finance management team, internal audit and the outside auditors).



There are two approaches to questionnaires in use today – very long and detailed checklists, such as those provided by Ernst & Young and PricewaterhouseCoopers to their clients, and shorter questionnaires more comparable to the approach Steve showed you in connection with full board reviews. When you have a chance to look at the sample Audit Committee evaluation questionnaires included with the materials, you'll notice that they are more aggressive in demanding comments than the typical board questionnaire. They include separate questions for the board and for the independent auditor, internal auditor and financial reporting team. That last group of questions uses a forced-ranking method so that they don't have to comment on whether the committee does a good or bad job in absolute terms, but rather indicate what are the relative strengths and weaknesses.

Depending on the kind of audit committee charter you have, the evaluation could produce amendments to that document. Many companies try to spell out not only the duties of the committee, but many of the specific tasks that the committee plans to undertake in order to fulfill those duties. I prefer restricting the charter to the goals and duties of the committee, which ought

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to be approved by the full board, and putting the tasks in a calendar, which can be approved by the audit committee. This provides more flexibility for adjusting tasks to circumstances. I also feel that the more the detail in the charter, the greater the chances that what happens in practice may be different – creating liability exposure.

The NACD's Commission Report on Audit Committtees a few years ago included a sample calendar for organizing audit committee tasks through the year. The tasks expected of audit committees have expanded, so the sample I've included in your materials is a little more detailed. You'll see that it's 2 pages – one listing tasks associated with the committee's oversight responsibilities and the other listing tasks associated with its organization, such as independence, evaluation and continuing education.

The Responsibility of the Audit Committee

- SEC Commentary on 301:
  - The audit committee has the responsibility for evaluating and determining that the audit team has the competence to conduct the audit according to GAAS
- Duty of Care
  - On an informed basis
  - after due consideration and deliberation of relevant issues
  - With appropriate input from legal and financial experts

Lets take the audit committee's direct responsibility, as per Section 301 of Sarbanes Oxley, to appoint the auditor. Assuming the listing rule uses the same language, I would recommend using the same language in the charter. SEC commentary on 301 in their proposed rulemaking points out that appointing the auditor involves evaluating and determining that the audit team has the competence to conduct the audit according to GAAS. We know from Holly's presentation on the duties of the board that the duty of care requires the audit committee to make its decision on an informed basis, after due consideration and deliberation and with input from appropriate legal and financial experts.

If you take a look at the second page of the Sample Calendar, there are 5 lines under "Independent Auditor". The next-to-last, scheduled for the 1st quarter meeting, is the selection of the auditor. Above that, scheduled for the preceding meeting, are reviews of independence and competence. Setting aside the time for those reviews hopefully takes care of due consideration and deliberation. The parenthetical says that it will be "(based on auditor's written report and

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management input)". Hopefully that will ensure that they get what they need to be deciding on an "informed basis". In practice they would also take into consideration the impressions of the audit teams qualifications and performance from the review of the audit, which you can see at the top of the other calendar page takes place at the same meeting at which the auditor is selected. Are the audit committee members themselves qualified to assess the audit team? Back on the organization page is the board of director's review of financial literacy and expertise in the 1st quarter meeting, which would be one opportunity to make that assessment, as would the committee evaluation that we can see toward the bottom is scheduled for the 4th quarter and 1st quarter meetings.

Audit Committee members can rely on management and advisors in order to avail themselves of the business judgment rule. Following the requirements of the listing standards, as mandated by Sarbanes Oxley Section 301, your Audit Committee Charter is going to give your audit committee access to independent advisors and to funds to pay for them. The challenge is to figure out when independent advisors make sense.

This clearly does not mean that the audit committee should have an independent advisory team all of the time. It does mean that we need to be on the lookout for conflict, and help the independent directors address the conflict. Remember the survey, where the directors' gave much more emphasis than general counsels did to their role of assisting with conflict issues.

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The Responsibility of the Audit Committee

- When is there enough potential conflict of interest to consider independent advisors?
  - Several SAS 82 Risk Factors Relating to Management?
    - Significant portion of management's compensation is contingent upon achieving unduly aggressive financial targets
    - An excessive interest in maintaining or increasing the earnings trend through aggressive accounting practices
    - High turnover of senior management, counsel or directors
  - If the problem is with items in already certified and disclosed financials?
  - If the problem was not brought to the Audit Committee's attention by management?

11

This slide has some ideas about when one should start thinking about conflict of interests in Audit Committee review of issues. If the question is whether management judgments or the decision to change accounting practice is warranted, one might look at the SAS 82 risk factors, perhaps taking notice if several seem to be in play. Here I've given some examples. There is also more potential conflict if the problem is with items already certified and disclosed. Management may not want to dig the issues back up at that point. Or if the problem came to the Audit Committee from a credible source other than management, and management should have been able to see it, that might be another cause for worry.

If you do feel that independent advice might be warranted, be careful that it doesn't make a potential problem into a real one.

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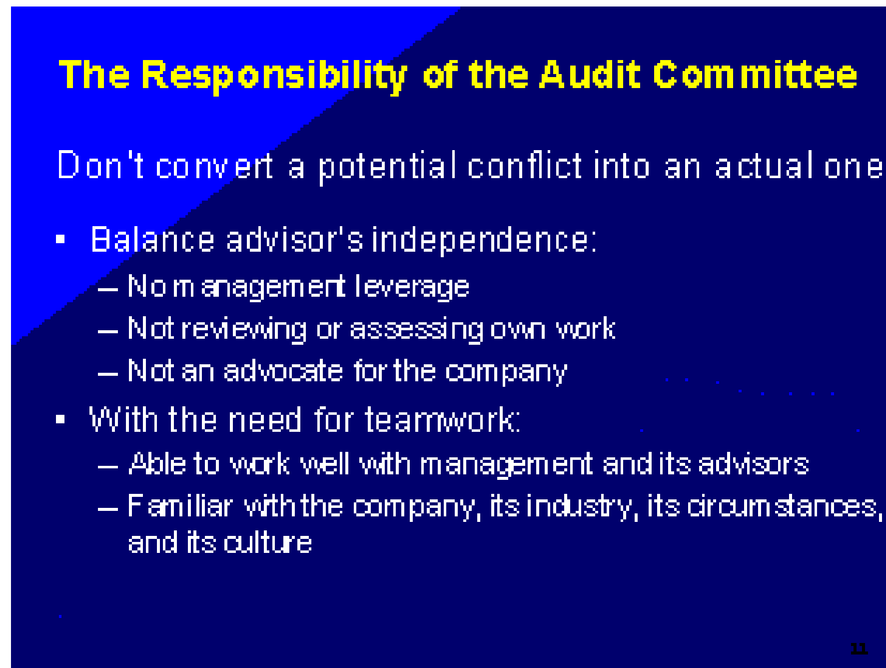

A final comment on recommending board processes in connection with the Audit Committee's changed role, and ensuring processes are in place to fulfill those duties. I do not believe audit committees or any other committee of the board should take on key roles outside their status as committees of the full board. If the law requires a specific decision by the audit committee, that is fine as long as it is subsequently ratified by the full board. In the event of a problem, the last thing we want is some directors pointing to other directors and saying that was their problem, not mine. The full board should feel responsible for what the audit committee is doing, and should be regularly briefed and should approve all key decisions based on those briefings.

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The use of special committees composed of independent directors to review whether derivative actions would be in the best interest of the corporation date back to the mid-1970s. Although there has been a lot of controversy, the majority of courts looking at the issue have held that the board may elect an independent committee, which has the power, at least in certain circumstances, to decide that a derivative suit should not proceed. Some jurisdictions, like New York, defer to the business judgment of an independent committee that has conducted an independent investigation even if directors that are implicated in the accusations of the shareholder plaintiffs represent a majority of the board, and other jurisdictions, following Delaware, do not entirely defer to the committee's judgment in those circumstances, but retain a limited power to review the committee's determination. It doesn't matter which approach your jurisdiction takes – what is interesting for our purposes here is how courts look at the formation of independent committees for this purpose and their investigative process.

One lesson of the cases is that waiting until you have a derivative claim before the board determines how the disinterested directors will be chosen can raise independence questions. The second circuit expresses the harshest view in this regard, holding that if most of the board is implicated in the litigation, then the members of the special litigation committee are in affect being appointed by the defendants of the litigation, and that causes a conflict of interest, which renders the business judgment rule inapplicable.

A second lesson is that the best independent directors to choose for the committee, if you have them, are ones who joined the board after the challenged transactions or conduct took place.

The special litigation committee cases also give us a look at what the courts consider to be good faith investigations. There should be a thorough written record of the investigation and its findings and recommendations. The committee members should actively involve themselves in the supervision of the investigation and in the evaluation of the facts uncovered. In upholding special litigation committee judgments, courts have emphasized that they interviewed numerous witnesses, reviewed depositions and relevant documents and questioned plaintiff's counsel as to the bases for their allegations. Where there was a prior investigation, the committee should take steps to assure itself of the independence and thoroughness of that prior report, carefully review the report and follow up any questionable items.

It is also interesting to note the basis on which the special litigation committee is supposed to make its decision. It is not simply a question of whether the plaintiff's claims have merit. In addition to the merits, the committee must consider the costs of the suit in relation to the anticipated recovery, the impact of the suit on the company's reputation, employees and other stakeholders, and any other harms or benefits involved.

Finally it is interesting to look at the attitude about the choice of counsel for the investigation. While the cases favor outside independent counsel, the ALI Principles of Corporate Governance take different positions depending on the circumstances. If the action is against an outside director or a corporate official below the general counsel's rank or position in the corporation, they could serve the committee and the corporation's principal outside corporate of securities counsel could as well. But if the general counsel is in a subordinate or reporting position to the

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officers accused in the suit, then neither the general counsel nor the corporation's principal outside counsel would be suitable. In all cases it is the committee that must decide.

With that in mind, now let us look at the Qualified Legal Compliance Committee concept. To deal with the potential conflict of having non-independent directors selecting the independent directors to be on the committee, the QLCC must have been previously established.

The QLCC must keep the CLO and CEO informed regarding the report of evidence of a material violation as well as the results of any investigation. If they determine that an investigation is necessary, they must notify the audit committee or full board, and initiate the investigation. The investigation may be conducted by the CLO or by outside attorneys – but I would recommend applying the ALI principles just mentioned. They must be able to retain any additional experts as the QLCC deems necessary.

At the conclusion of the investigation, they must recommend, by majority vote, that the company implement an appropriate response and let the CLO and CEO know what that response should be.

Let me just briefly comment on the third category of independent director review of special situations – their review of related party transactions. Both the NASDAQ proposed listing standards and the final report of the ABA Task Force on Corporate Responsibility talk about having independent directors review related party transactions. I agree that review of related party transactions, along with top executive use of company assets and executive perquisites should all be subject to formal review by independent directors. I would just suggest that this is yet another area of governance where your first stop should be to review the state corporation law on the subject, and the ALI principles of corporate governance are a convenient way to do that.

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Audit Committee Self-Assessment Questionnaire
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Please assess each item by circling a number on the right, from 1 for "I don't agree" to 3 for "I completely agree". Many items cover several issues, so please use the blank space under each item to indicate what the particular problem (or positive attribute) is. After each section there is space for additional comments and suggestions related to that topic.

Purpose	Don't Agree	Partially Agree	Complete Agree
1. The committee's mission and responsibilities are clearly presented in a company-specific charter approved by the full board, understood by all committee members, and used to guide committee activities.	1	2	3
2. The respective roles of the committee, the full board, the financial reporting team, internal audit and external audit are well understood by each of those groups. It is clear which aspects of internal control, legal compliance, and risk oversight are overseen by the committee on behalf of the board.	1	2	3
3. The committee takes seriously its responsibility to initiate investigations and engage outside resources to assist, as appropriate, if circumstances so require, and is ready to respond appropriately to any reports from employees, attorneys, auditors or third parties regarding material violations of law, breaches of fiduciary duty or serious concerns with financial reporting or internal controls.	1	2	3

1. The committee's mission and responsibilities are clearly presented in a company-specific charter approved by the full board, understood by all committee members, and used to guide committee activities. — 1 2 3

   What can be improved: ____

2. The respective roles of the committee, the full board, the financial reporting team, internal audit and external audit are well understood by each of those groups. It is clear which aspects of internal control, legal compliance, and risk oversight are overseen by the committee on behalf of the board. — 1 2 3

   What can be improved: ____

3. The committee takes seriously its responsibility to initiate investigations and engage outside resources to assist, as appropriate, if circumstances so require, and is ready to respond appropriately to any reports from employees, attorneys, auditors or third parties regarding material violations of law, breaches of fiduciary duty or serious concerns with financial reporting or internal controls. — 1 2 3

   What can be improved: ____

   Other comments on the committee's purpose: ______________________________

   ____

Composition

4. The committee membership reflects an optimal mix of financial, audit and other relevant business talent to address the company's range of issues and risks. — 1 2 3

   What can be improved: ____

Composition (continued)

	Don't Agree	Partially Agree	Complete Agree
5. Every member of the committees comes to meetings prepared, having reviewed the materials provided in advance and has thought about the key matters to be reviewed at the meeting.	1	2	3

What can be improved: ____________________

6. All members of the committee are independent in mindset as well as relationships, bringing consistently objective insight to all aspects of monitoring and oversight activities. They are selected in a manner that avoids any appearance of dependence on the chief executive officer or chief financial officer.	1	2	3

What can be improved: ____________________

Other comments on the committee's composition: ____________________

____

Process

7. The committee's planning calendar reflects the current environment and requirements, and spells out the specific tasks of the committee, as well as the dates on which those tasks are to be performed, clearly and completely.	1	2	3

What can be improved: ____________________

8. Audit committee members receive, sufficiently in advance of each meeting, a clear and succinct agenda reflecting all tasks required to be done at that meeting, together with concise and complete support materials.	1	2	3

What can be improved: ____________________

9. Meeting time is managed effectively with the right balance of pre-read materials, active dialogue on relevant issues, prepared questions and follow-up of unresolved matters. Each committee member has an opportunity to focus discussion on the issues that they deem important.	1	2	3

What can be improved: ____________________

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Process (continued)

	Don't Agree	Partially Agree	Complete Agree
10. Adequate time is spent in executive sessions with management, internal audit, the independent auditors, and the chief compliance officer, and sufficient time is spent without those representatives to discuss and assess the quality and sufficiency of financial reporting, risk oversight and the audit function.	1	2	3

What can be improved: ____

11. New member orientation and continuing education ensures familiarity with applicable rules, relevant industry specific risks, organizational strategies and key responsibilities.	1	2	3

What can be improved: ____

12. The committee has regular access to management, internal auditors, and the independent auditors, and periodic access to other levels of financial management, as well as any outside counsel or support that it requires..	1	2	3

What can be improved: ____

13. Committee reports to the full board include all important issues discussed and convey the committee's candid assessment of the quality and sufficiency of financial reporting, risk oversight and the audit function.	1	2	3

What can be improved: ____

Other comments on the committee's composition: ______________________________

____

General Recommendations

General recommendations for improvement of the committee's performance or to enhance the committee's effectiveness or contributions:

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Board of Directors Questions For Audit Committee Evaluation

The following questions can be included in the general board evaluation questionnaire:

	Needs to Improve	Consist. Good	Excellent
1. The Board has the appropriate committees to enable it to discharge its responsibilities in an effective and timely fashion (or should Committees be added or eliminated?).	1	2	3
2. Audit committee responsibilities are appropriate to enable the Board to discharge its responsibilities effectively – none of the matters currently handled by the whole board should be handled by the audit committee (and vice versa).	1	2	3
3. The audit committee has the right priorities and the committee achieves those objectives and keeps the entire board informed about all important matters reviewed by the committee.	1	2	3
4. Audit committee reports to the board are timely, clear and focused; and provide the board with a complete assessment of the quality and sufficiency of financial reporting, risk oversight and the audit function.	1	2	3
5. Please rate the overall quality and performance of the audit committee.	1	2	3

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Support Team Questionnaire
For Audit Committee Evaluation

Please rank each of the following 10 statements in the order in which you believe that they are true and reflect a particular strength of the committee. A high number will indicate a statement that is truer and reflects a greater relative strength than a low number. If you don't feel in a position to answer a question, write "N/A" and rank the rest. Answers from the the independent auditor, internal audit, the chief financial officer, the chief accounting officer, the secretary and the general counsel will be combined so that the anonymity of each completed questionnaire will be preserved.

Rank

1. The committee covers the issues and asks the questions necessary to address:

a) The risk that the financial statements may be materially misstated; ___

b) The appropriateness of the accounting principles followed by the company and any changes in accounting principles; ___

c) The soundness of management judgment regarding accounting accruals, reserves, other estimates, discretionary changes in accounting principles. ___

2. Each member of the committee seems to understand:

a) Unusual or complex items and their accounting treatment when presented to and discussed by the committee; ___

b) The significant business, financial, and financial reporting risks faced by the company in the current environment; ___

c) The extent to which control testing by the internal and independent auditors can be relied on to detect internal control problems or fraud; ___

3. The committee and each of its members seems receptive and would be supportive should you ever need to privately express concerns about legal compliance, ethical issues, or accuracy of financial reporting. ___

4. The committee's process ensures follow-up from one meeting to the next on unresolved issues, unanswered questions and requested information. ___

5. The committee would be capable, if circumstances required, of conducting a special investigation and engaging outside assistance, without support of management. ___

6. The committee makes itself familiar enough with all relationships among the independent auditors, internal audit, and the financial management team, as well as between each of them and the company, to be able to assess independence. ___

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Audit Committee Charter

Committee Membership

The Audit Committee of the Board of Directors of the Company shall consist of at least three Directors. The members of the Committee shall be appointed by the Board, upon the recommendation of the Nominating Committee and may be removed by the Board at its discretion. All members of the Committee shall, in the Board's judgment, meet the applicable independence requirements of the New York Stock Exchange ("NYSE") and all other applicable laws and regulations, and shall have sufficient financial experience and ability at the time of appointment to the Committee, or within a reasonable period of time thereafter, to discharge their responsibilities. At least one member of the Committee shall, in the Board's judgment, qualify as an "audit committee financial expert" as defined by applicable regulations.

The Committee's Purpose

The purpose of the Audit Committee is to assist the Board in its oversight of the integrity of the Company's financial statements, legal and regulatory compliance, the independent auditor's qualifications and independence, and the performance of the Company's internal audit function and of the independent auditors.

The Audit Committee shall prepare an annual committee report for the Company's annual proxy statement.

Committee Authority and Responsibilities

The authority and responsibilities of the Audit Committee are:

1. To recommend for shareholder approval, the independent auditor to audit the accounts of the Company for the year. The Committee shall have the sole authority and responsibility to appoint, retain, evaluate and terminate the independent auditors, to approve all audit engagement fees and terms and to pre-approve any permitted non-audit services provided by the Company's independent auditor, consistent with applicable law and regulation. The Committee may delegate to one or more committee members the pre-approval of permitted non-audit services by the independent auditor.
2. To review with the independent auditor the scope and results of the audit, and any audit problems or difficulties and management's response (including resolution of any disagreement between management and the auditor regarding financial reporting).
3. At least annually to obtain and review a report by the independent auditor describing the firms internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm or

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by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and describing all relationships between the independent auditor and the Company.

4. To discuss the Company annual audited financial statements and quarterly financial statements with management and the independent auditor, including The Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations", and all matters raised by the independent auditors pursuant to applicable standards, and to determine whether to recommend to the Board that the audited financial statements be included in The Company's annual report on Form 10-K.
5. To review with management, the internal audit department and the independent auditor the adequacy and effectiveness of the Company's disclosure and internal control procedures, including any material changes or deficiencies in such controls.
6. To discuss with management the Company's risk assessment and risk management policies.
7. To discuss the Company's earnings press releases, as well as the type of financial information and earnings guidance which was provided to analysts and rating agencies since the previous Committee meeting.
8. To review the Company's financial reporting and accounting standards and principles, significant changes in such standards or principles or in their application and the key accounting decisions affecting the Company's financial statements, including alternatives to, and the rationale for, the decisions made.
9. To set policies for the hiring of employees or former employees of the Company's independent auditors.
10. To review with the internal audit department the status and results of the annual internal audit plan and the sufficiency of the department's resources.
11. To establish procedures for the receipt, retention and treatment of complaints from the Company employees regarding accounting, internal accounting controls, or auditing matters, as well as for confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

Committee Meetings, Support and Evaluation

12. The Audit Committee shall meet at least quarterly, keep minutes of its proceedings and report regularly to the Board.
13. The Audit Committee shall meet separately in executive session with representatives of the Company's independent auditors and representatives of the Company's internal audit department at least quarterly, and with representatives of management periodically as the Committee deems appropriate. The Committee shall also have unlimited access, as appropriate, to Company management, it's internal audit department, and other Company personnel.

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14. The Audit Committee has the authority to retain independent legal, accounting or other consultants in its sole discretion and to approve related fees and retention terms. The Committee shall also receive any funding it deems necessary or appropriate for ordinary administrative expenses.

15. The Audit Committee shall conduct and present to the Board an annual performance evaluation of the Committee. The Committee shall review annually the adequacy of this charter and recommend any changes that it deems appropriate to the Board for approval.

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Audit Committee: Key Practices (GE example)
The audit committee has adopted the following key practices to assist it in undertaking the functions and responsibilities set forth in its charter:

1. **Meetings**. The committee will meet at least 7 times a year, generally on a day different than the regularly scheduled board meeting to allow time for in-depth discussion.

2. **Review of Financial Statements**. The committee will review the company's 10-K in detail with the CEO, the CFO and the full board at an extended February board meeting. The committee will meet to review the company's 10-Qs with the CFO. The head of the corporate audit staff and the company's independent auditor will be present at these meetings.

3. **Quarterly Review of CEO and CFO Certification Process**. In conjunction with its reviews of the 10-Ks and 10-Qs, the committee will also review the process for the CEO and CFO quarterly certifications required by the SEC with respect to the financial statements and the company's disclosure and internal controls, including any material changes or deficiencies in such controls. The committee shall also meet twice a year with the corporate disclosure committee responsible for reviewing the company's disclosure controls and procedures.

4. **Review of Earnings Releases and Information Provided to Analysts and Rating Agencies**. The CFO shall review earnings releases with the chair of the committee prior to their release to the public. Prior to the event, the CEO or the CFO shall review with the committee, or the full board, the substance of any presentations to analysts or rating agencies which constitute a shift in company strategy or outlook. In addition, the CEO or CFO shall review subsequently with the committee, or the full board, a summary of major presentations that have been given to analysts or rating agencies that do not constitute a shift in strategy or outlook.

5. **Approval of Audit and Non-Audit Services**. In addition to approving the engagement of the independent auditor to audit the company's consolidated financial statements, the committee will approve all use of the company's independent auditor for non-audit services prior to any such engagement. To minimize relationships which could appear to impair the objectivity of the independent auditor, it is the committee's practice to restrict the non-audit services that may be provided to the company by the company's independent auditor primarily to tax services and merger and acquisition due diligence and integration services. The company will obtain such limited non-audit services from the company's auditor only when the services offered by the auditor's firm are more effective or economical than services available from other providers, and, to the extent possible, only following competitive bidding for such services.

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6. <u>Hiring Guidelines for Independent Auditor Employees</u>. The committee has adopted the following practices regarding the hiring by the company of any partner, director, manager, staff, advising member of the department of professional practice, reviewing actuary, reviewing tax professional and any other persons having responsibility for providing audit assurance to the company's independent auditor on any aspect of their certification of the company's financial statements. "Audit assurance" includes all work that results in the expression of an opinion on financial statements, including audits of statutory accounts.

a. No member of the audit team that is auditing a GE business can be hired into that GE business or into a position to which that business reports for a period of 2 years following association with that audit.
b. No former employee of the independent auditor may sign a GE or GE affiliate's SEC filing for 5 years following employment with the independent auditor.
c. No former employee of the independent auditor may be named a GE or major affiliate officer for 3 years following employment by the independent auditor.
d. GE's CFO must approve all executive-band and higher hires from the independent auditor.
e. GE's CFO shall report annually to the audit committee the profile of the preceding year's hires from the independent auditor.

7. <u>Process for Handling Complaints about Accounting Matters</u>. As part of the board's procedure for receiving and handling complaints or concerns about the company's conduct, the committee has established the following procedures for: (i) the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters; and (ii) the confidential, anonymous submission by GE employees of concerns regarding questionable accounting or auditing matters.

a. GE has established and published on its website special mail and e-mail addresses and a toll-free telephone number for receiving complaints regarding accounting, internal accounting controls, or auditing matters.
b. All such complaints will be sent to the presiding director and to the chair of the audit committee.
c. All complaints will be tracked on a separate board of directors' ombuds docket, but handled by the company's ombuds, finance and legal staffs in the normal manner, except as the audit committee may request.
d. The status of the specially docketed complaints will be reported on a quarterly basis to the presiding director and the chair of the audit committee and, if they so direct, to the committee or the full board.

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e. The presiding director or audit committee chair may request special treatment, including the retention of outside counsel or other advisors, for any complaint addressed to them.

The company's integrity manual prohibits any employee from retaliating or taking any adverse action against anyone for raising or helping to resolve an integrity concern.

8. Audit Committee Memberships. The committee has determined that in view of the increasing demands and responsibilities of the audit committee, members of the committee should not serve on more than two additional audit committees of other public companies, and the chair of the committee should not serve on more than one other audit committee of a public company. Existing relationships exceeding these limits may continue in place provided that the full board of directors determines that such relationships do not impair the member's ability to serve effectively on the committee.

9. Code of Ethics For CEO and Senior Financial Officers. GE's integrity manual, *The Spirit & Letter of Our Commitment*, applies to all of the company's employees, including the CEO and all financial professionals. GE's policy 30.5, *Conflicts of Interest*, and policy 30.7, *Controllership*, require all employees, including the CEO and senior financial officers, to resolve ethically any actual or apparent conflicts of interest, and to comply with all generally accepted accounting principles, laws and regulations designed to produce full, fair, accurate, timely, and understandable disclosure in the company's periodic reports filed with the SEC. Annual acknowledgement of the *Spirit & Letter* is required of all salaried employees, including the company's CEO and financial professionals.

10. Conflict of Interest Review. The committee will review twice a year the corporate audit staff's audit of the application of GE's policy 30.5, *Conflicts of Interest*, to the company's officers.

11. Member With Financial Expertise. To add a member of the board and the committee with extensive financial expertise, on October 28, 2002, the board elected Robert J. Swieringa, dean of the S. C. Johnson Graduate School of Management and professor of accounting at Cornell University, to the board and appointed him to the committee. Prior to becoming dean of the Johnson School in 1997, Dr. Swieringa was a member of the Financial Accounting Standards Board from 1986 to 1996. He was also president of the Financial Accounting and Reporting Section of the American Accounting Association in 1998 and 1999. At its February 2003 meeting, the board of directors determined that Dr. Swieringa, as defined by the SEC rules, is both independent and an audit committee financial expert.

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12. Audit Partner Rotation. The committee shall ensure that the lead audit partners assigned by the company's independent auditor to the company, and to each of its subsidiaries that have securities registered with the SEC, as well as the audit partner responsible for reviewing the company's audit shall be changed at least every five years.

13. Shareowner Ratification of Independent Auditor. Although the committee has the sole authority to appoint the independent auditor, the committee will continue its longstanding practice of recommending that the board ask the shareowners, at their annual meeting, to approve the committee's selection of independent auditor.

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Nominating Committee Charter

Committee Membership

The Nominating Committee of the Board of Directors of the Company shall consist of at least three Directors. The members of the Committee and its Chair shall be appointed by the Board and may be removed by the Board at its discretion. All members of the Committee shall, in the Board's judgment, meet the applicable independence requirements of the New York Stock Exchange. [GE's nominating and corporate governance committee includes, as members, the chairs of its audit and comp committees].

The Committee's Purpose

The purpose of the Nominating Committee is to assist the Board in identifying qualified individuals to become Board members, nominate Directors to serve on and to chair the Board Committees, periodically review director compensation and benefits, and recommend to the Board any improvements to the Company's corporate governance guidelines as it deems appropriate. The Committee shall also assist the Board in continuing education, new director orientation and assessment of board effectiveness.

Committee Authority and Responsibilities

The authority and responsibilities of the Nominating Committee are:

1. To lead the search for individuals qualified to become members of the Board. In obtaining the names of possible new nominees, the Committee may make its own inquiries and will receive suggestions from other Directors, stockholders and other sources. All potential nominees must first be considered by the Committee before being contacted as possible nominees and before having their names formally considered by the full Board.

2. To evaluate the suitability of potential nominees for membership on the Board, taking into consideration the Board's current composition, including expertise, diversity, and balance of inside, outside and independent directors, and considering the general qualifications of the potential nominees, such as:

   (a) Unquestionable integrity and honesty,
   (b) The ability to exercise sound, mature and independent business judgment in the best interests of the shareholders as a whole,
   (c) Recognized leadership in business or professional activity,
   (d) A background and experience which will complement the talents of the other Board members

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(e) Willingness and capability to take the time to actively participate in Board and Committee meetings and related activities,
(f) Ability to work professionally and effectively with other Board members and The Company's management,
(g) An age to enable the Director to remain on the Board long enough to make an effective contribution,
(h) Lack of realistic possibilities of conflict of interest or legal prohibition.

and see that all necessary and appropriate inquiries are made into the backgrounds of such candidates.

3. To recommend to the Board the number and names of proposed nominees for election as Director at the Annual Meeting of Shareholders and, in the case of a vacancy on the Board, the name of an individual to fill the vacancy.

4. To monitor trends and best practices in corporate governance, periodically review the corporate governance guidelines and recommend changes as it deems appropriate in those guidelines, in the corporate governance provisions of the Company's By-Laws, and in the policies and practices of the Board, including:

   (a) Retirement age and resignation policies,

   (b) Other board service, conflict of interest issues and other affiliations,

   (c) Schedule, agendas and conduct of executive sessions.

5. To monitor trends and best practices in Director compensation, benefits and stock ownership guidelines and recommend changes to the Board as it deems appropriate. Compensation should fairly pay Directors for work required in a company of _______'s size and scope; should align Directors' interests with the long-term interests of the shareholders; and should be simple.

6. To annually review and make recommendations to the Board regarding its process for evaluating the effectiveness of the Board and its Committees. The Committee shall oversee the annual assessment of board effectiveness and report to the Board.

7. To periodically review and make recommendations to the Board regarding new Director orientation and Director continuing education.

8. To annually recommend to the Board following the annual meeting of shareholders, committee membership and chairs and review periodically with the Board Committee rotation practices.

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Committee Meetings, Support and Evaluation

The Nominating Committee shall meet at least (two times) a year, or more often as circumstances require, keep minutes of its proceeding and report regularly to the Board.

The Nominating Committee may invite to its meetings any director, officer of the Company or such other person as it deems appropriate to assist it in performing its responsibilities, and has the authority to retain independent search or other consultants to assist it in identifying potential Director nominees, and to terminate any such search, in its sole discretion, and to approve related fees and other retention provisions.

The Nominating Committee shall conduct and present to the Board an annual performance evaluation of the Committee. The Committee shall review annually the adequacy of this charter and recommend any changes that it deems appropriate to the Board for approval.

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Audit Committee Calendar

	Quarters				As
Oversight	**2nd**	**3rd**	**4th**	**1st**	**Ness**
Audit					
Pre-approval of audit services (initial, follow-up and delegated pre-approvals)	X	X	X	X	
Review of internal and independent. audit plan, including planned scope of quarterly reviews		X			
Review of audit issues w/ independent. auditor, internal audit, management (exec. sessions)				X	X
Review of material communication between auditor and management				X	
Financial Disclosure					
Review of annual financials and auditor report for 10-K (incl. recommendation to Board)				ACC	
Review of interim financial statements	X	X	X	X	
Review of accounting principles and quality of presentation (incl. significant changes)				X	
Review of information and presentation in earnings releases and analyst communications	X	X	X	X	
Internal Controls					
Review of internal controls with indep. auditor, internal audit, management (exec. sessions)			X		
Independent auditor's report on management's assessment of internal controls				X	
Review of changes in, or affecting, internal controls					X
Compliance					
Fraud involving internal controls					X
Complaints or concerns received by the company, investigations initiated by the committee					X
Disclosure laws and regulations					X
Conflicts of interest in related party transactions					X
Code of ethics for CEO and financial executives					X
Financial Risk Management					
Review major exposures and steps taken to manage them			X		

Key: ACC – Committee Conference Call, X – Committee Meeting, BoD – Board of Directors Meeting; CM – Committee Member

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Audit Committee Calendar

Organization	Quarters 2nd	3rd	4th	1st	As Ness
Audit Committee Charter					
Review and recommendations by Audit Committee	X				
Approval by Board of Directors	BoD				
Audit Committee Members and Chair					
Review of independence				BoD	
Review of financial literacy and expertise				BoD	
Internal Audit					
Review of internal audit charter	X				
Review of organization, compensation and resources	X				
Independent Auditors					
Review of Independence (based on review of services & auditor's written report)			X		
Review of Competence (based on auditor's written report and management input)			X		
Confirm management compliance with hiring guidelines			X		
Selection of independent auditor for board and stockholder approval				X	
Compensation of auditors for audit-related matters				X	
Committee Counsel or Advisors					
Selection or compensation					X
Committee Evaluation					
Questionnaire			X		
Discussion				X	
Continuing Education					
Regulatory and accounting changes and initiatives		X			X

Key: ACC – Committee Conference Call, X – Committee Meeting, BoD – Board of Directors Meeting; CM – Committee Member

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Corporate Governance Ratings Comparison

By Broc Romanek, Editor, TheCorporateCounsel.net

(last updated 3/18/03)

A. Institutional Shareholder Services
B. GovernanceMetrics International
C. The Corporate Library
D. Moody's Investors Service
E. Standard & Poors

This comparison is a one-stop resource to compare the "nuts n' bolts" of the growing number of services providing ratings on corporate governance practices. It will be updated continuously as the rating industry matures.

A. Institutional Shareholder Services (http://www.isscgq.com/)
1. Background
ISS's core services include global proxy services and database and research tools for institutional investors. These services are available by subscription and include a weekly informational newsletter and annual updates to the *ISS Proxy Voting Guide.* The *ISS Proxy Voting Guide* is a reference manual designed to provide recommendations to institutional shareholders, especially ERISA managers, on how to satisfy their obligations as shareholders and vote their stock to enhance long-term portfolio value.

Before launching its "Corporate Governance Quotient" or "CGQ" rating service last year, ISS had been working on it for almost two years. [It is important to note that CGQ is for investment decisions – not proxy advice. So its entirely possible for a company to have a low CGQ rating and yet have ISS recommend that shareholders vote for management's proposals.] A demonstration of the CGQ ratings is available at http://www.isscgq.com/demo.

2. Calculation of Ratings
* **Which Companies -** For the 2003 proxy season, ISS expects to post two CGQ scores on the first page of every proxy voting report it issues for its 9,500 domestic-company universe. As of early March 2003, it was able to do so for 6,000 companies. [Interestingly, as ISS adds smaller companies to its database – the scores of companies that have already been rated have gone up considerably as larger companies tend to have better governance practices.]
* **Scoring System -** Both scores are expressed as a percentile, relative to all other peer companies (100 is the best score; 0 is the worst). The first score shows how the company's corporate governance practices stack up against all other companies in their relevant S&P or Russell market index. The second score ranks each company relative to peers in S&P's 23 industry groups. For example, a 65/77 score means that the company outscores 65% of the companies in its index and 77% of the companies in its industry.
* **Topics -** ISS ratings are based on 8 "core topics," with 61 sub-topics. The eight core topics are: auditor independence; board structure and composition; "anti-takeover" charter and bylaw provisions; laws in the company's state of incorporation; executive and director

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compensation; qualitative factors, including financial performance; D&O stock ownership; and director education. A current list of the rating variables and their distribution among the eight core topics is available at http://www.isscgq.com/RatingCriteria.htm

Overall, ISS already has factored the proposed SRO listing standard changes into its rating calculations. In some cases, ISS has gone even farther than what the NYSE and Nasdaq have proposed.

Some of the topics are analyzed in connection with others, so if a company has multiple "good points" - it can help the company receive a higher rating than if each point was earned individually. Presumably, the demerits work the same way.

ISS does not fully explain how the points are awarded, their values, relative weights, or the way the combinations and permutations play out. Some companies have spent $10,000-$25,000 to hire ISS to work with them in a consulting capacity on their corporate governance framework. Many companies complain about this aspect of ISS' framework as they feel they have to pay money just to understand how the rating process works.

However, based on analysis conducted by an investment banker, a number of the sub-topics have been identified as major differentiators Topics that are not common to many companies so meeting these criteria gives a leg up. Topics that are not differentiators means that companies uniformly meet – or do not meet – the criteria. One example is incorporation in Delaware that gives companies a middle of the road score for that category – and many companies are incorporated in that state.

As of March 2003, the major differentiators included:

* board composition – over 2/3 independent directors (and independence is defined differently for ISS purposes as compared to the SROs)
* board structure – not having a staggered board
* limits on outside directorships – no more than 4 boards
* outside advisors available to board – include this availability in charters and/or governance guidelines
* capital stucture – don't have dual classes or uneven voting rights

Criteria that have less significant importance but that are still differentiators included:

* corporate governance guidelines – publicly available and updated
* chairman/CEO separation – identification of a lead director (must be a "real" lead director and not a "presiding" lead that rotates around the board)
* poison pill features – must not be so onerous as to prevent shareholders from exercising a voice
* company loans to officers – related party transactions are closely scrutinized, including grandfathered loans under Section 402
* options expensing – announcement of intention to do so with a specific implementation date

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* stock ownership guidelines – directors and officers required to purchase company stock and hold stock received as part of compensation package

It is important to note that ISS only takes into consideration information that is made publicly available. Thus, a company might meet some of the criteria and tell ISS staffers so – but ISS won't take it into account unless its on a web site, in a SEC filing or somehow otherwise put into the public domain.

3. Corporate Input into Ratings

Although ISS does its own homework in developing ratings, it also relies on companies to participate in the process and make corrections. This is done by companies going to the ISS website - http://www.isscgq.com/- and entering information about their governance structures that might correct or supplement what ISS has on file. Companies can do this without charge.

This information is inputted by appending documents that are publicly available right into a database through the ISS website. There is a column on the website for a company to note that it "disagrees" with selected information that ISS has used in its rating calculation. It is wise for a company to also call or email your ISS contact at the same time a disagreement is noted on the website.

In February 2003, ISS began a 24/7 system so that companies can continuously input new data. However, this data will not affect a company's scores until the next cycle of updated calculations – which occur every 120 days. However, it is our understanding that if companies subscribe to ISS' fee-based consulting service, they can alter their scores as they input the data.

To input information, companies can get their log-ins and passwords from either Ted Seaton (edward.seaton@issproxy.com) or AJ Patterson (ahaseem.patterson@issproxy.com).

4. How Often are Ratings Calculated

In general, once a company gets rated, ISS will update the rating on a 120 day cycle. However, it is our understanding that if companies subscribe to ISS' fee-based consulting service, they can alter their scores as they input new data.

5. How a Company Can Ascertain its Rating

Often, companies find out their ratings through the grapevine (i.e. through institutional investors that are ISS customers). ISS doesn't routinely inform companies of their ratings, even if they input data through the ISS website (unless the company pays for the consulting service).

At this time, the exception is that ISS will provide companies with their rating once per year – if they go to ISS and ask for it. This request should go to Kevin McManus (kevin.mcmanus@issproxy.com). Companies that ask more than once per year have to pay to receive their ratings – but we haven't heard what the cost is yet.

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B. GovernanceMetrics International

1. Background

GovernanceMetrics International (GMI) was founded in 2000 by PR advisor Gavin Anderson, IR pro Gary Kraut and governance experts Stephen Davis and Jon Lukomnik (formerly of NYCERS). ISS alum Howard Sherman is the chief operating officer. Their sophisticated methodology took over 2 years to launch.

GMI's research reports and scores primarily are developed for security analysts, portfolio managers and compliance officers, not the persons that make voting decisions (although GMI points out that their reports can be useful in contested votes in that they offer an independent point of view.) These managers pay upwards of $18,000 per year for a subscription to the GMI database. Although GMI wouldn't say how many customers have signed up, they say that current users have about $2 trillion under management.

2. Calculation of Ratings

* **Which Companies** – As of March 2003, GMI rates companies in the S&P 500. GMI intends to triple that number by the end of 2003, including 500 non-U.S. companies.

* **Scoring System** – GMI rates and compares 600+ data points against those of all other companies in its research universe using an "asymmetric geometric scoring algorithm" and boils them down to a 10-point score ("1" is lowest and "10" is highest).

GMI scores are relative and each company is scored against the all other companies measured - and also against all those in the same country of domicile. Companies are initially assigned 8 ratings in all, an overall GMI rating and one for each category of analysis. Each company's rating report includes a summary of the company's overall governance profile and commentary on each of the seven broad categories of analysis. In addition to an overall GMI rating, each of the seven research categories receives a separate rating. These are meant to help subscribers see where a company is particularly strong or weak.

The 600 data points are structured so that they can only produce "yes", "no" or "not disclosed" answers. This enables GMI to eliminate a large degree of subjectivity in its metrics as its cadre of analysts cull through publicly available information.

* **Topics -** GMI employs a whopping 600 metrics covering seven broad categories including:

- board accountability,
- financial disclosure and internal controls,
- executive compensation,
- market for control,
- ownership base and potential dilution,
- "corporate behavior" (includes matters like environment, labor and foreign-sourcing practices), and
- shareholder rights.

These seven categories then have scores of subcategories. Each individual metric has a numerical value and each sub-section and research category is weighted according to investor interest.

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GMI derives its rating criteria from a variety of public sources, such as stock exchange listing requirements and model corporate governance codes like the OECD. In addition, the criteria incorporate the views of GMI's corporate governance and legal advisors as well as input institutional investors, corporate officers and company directors.

The use of asymmetric geometric scoring tends to magnify the impact of "outliers." This includes both those with the very best practices – who are then rewarded more – or those with the worst – who are penalized.

3. Corporate Input into Ratings
All companies rated by GMI are given a chance to review their data entry report and provided 10 business days to review and respond. At this time, there is no web-based system to input data. Instead, companies should contact Howard Sherman (mailto:(hsherman@gmiratings.com).

For $50,000, companies can hire GMI to conduct a comprehensive corporate governance review that results in a lengthy report that is made publicly available. This review is quite involved – including interviews with directors and officers – and takes several weeks. It does not include advice on how to improve governance practices and in contrast to the service offered by Standard and Poor's, companies undertaking a comprehensive rating with GMI understand the final report will be shared with GMI subscribers (S&P allows companies to keep their reports internal.)

4. How Often are Ratings Calculated
At this time, GMI plans to re-rate companies approximately every six months. Ratings for US companies will be recalculated at the end of the proxy season, since this is the time that companies disclose a lot of new information.

In between these rating periods, GMI monitors each company in its research universe on a daily basis and posts "Updates" as necessary. This can be helpful for companies to keep tabs on what peers are doing. GMI also provides a "red flag" service to alert subscribers about a governance issue that it thinks has the potential to affect shareholder value. E.g., GMI flags excessive potential dilution from stock option plans.

5. How a Company Can Ascertain its Rating
Companies can obtain their first rating report at no charge by contacting Howard Sherman (mailto:(hsherman@gmiratings.com). After that, they can obtain a ratings summary for free - or pay $1,000 for the full report.

C. The Corporate Library (http://www.thecorporatelibrary.com/products/boardanalytics.html)
1. Background
The Corporate Library was founded during mid-1999 by Nell Minow and Robert A.G. Monks, long-time partners in Lens Investment Management and co-founders of Institutional Shareholders Services. The site is a repository of corporate governance information.

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The Corporate Library will launch its "Board Analyst" rating system just after the 2003 season. Investors can purchase access to the Board Analyst database for $8,000 to $35,000 per year, depending on the number of users and add-ons. The full ratings version is priced at $18,000 per year for up to three users.

2. Calculation of Ratings

* **Which Companies** - Board Analyst provides thorough coverage of over 1700 domestic companies - and more limited coverage of 250 international companies. These include all US companies with market caps in excess of $1 billion as of July 2002 - and incorporate the full S&P 500 and Russell 1000 indices.
* **Scoring System** – Board Analyst issues "A through F 'Board Effectiveness Ratings'" on boards as a whole. Board Analyst also provides a comparative best practices benchmark score using the same system - as well as Sarbanes-Oxley and SRO listing requirement compliance percentage scores.
* **Topics** – Board Analyst's Board Effectiveness Ratings are based on several proprietary indicators, including:
* the company's ownership profile (indexed stocks and controlled companies are held to higher standards of board independence and strength than other firms),
* the personal shareholdings of outside directors (to insure a strong alignment of interest between these directors and the shareholders they represent),
* CEO compensation policies and practices (focused on the alignment of interest established and maintained by the board between the CEO's compensation and shareholder interests), and
* overall board composition (problem areas covered in this last category might an excessive number of aging directors, or directors who have served on the board for too long, too many directors who are either active CEOs at other firms or sit on too many boards, retired CEOs who continue to serve as Chairman, and so on).

These scores may also include adjustments for accounting oversight failures, poor strategic decision-making by the board, including the approval of ill-advised M&A activities and shareholder unfriendly takeover defenses.

The best practices benchmark score is based on the OECD principles of good corporate governance – and are intended to help differentiate Board Analyst's Board Effectiveness Ratings that consider only a few statistically significant factors – as compared to other ratings systems that tend to rely more on best practices checklists.

3. Corporate Input into Ratings

Companies can regularly review their ratings at no cost. Company comments will be incorporated – unedited – into each company's ratings profile. The Corporate Library does not accept consulting revenues from the companies it rates.

4. How Often are Ratings Calculated

Board Analyst governance data for U.S. companies is updated continually throughout the year as CEO and director changes are announced. In addition, The Corporate Library monitors and posts 8-K announcements on a weekly basis. Other information, however, such as committee

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assignments, may only be updated annually - as most companies do not reliably disclose such information between proxies.

International data is generally updated annually.

Board Effectiveness Ratings may change when this data is received - although major shifts are reviewed by senior staff on a case-by-case basis. Substantial changes are most likely to occur during proxy season, as new polices and practices are more fully disclosed.

Companies in bankruptcy or undergoing significant reorganizations will generally be rated a "C" for at least six months - to give the new board time to demonstrate its relative strengths and weaknesses.

Performance data updates are made for most firms on a quarterly basis (Jan 1, Apr 1, Jul 1, Oct 1.) This data includes one, three and five year total shareholder return results, as well as 52 week "Hi" and "Lo" share prices. This performance data is compared against both the S&P 500 index and company peers.

5. How a Company Can Ascertain its Rating
Companies may contact The Corporate Library about their ratings via email at ratings@thecorporatelibrary.com - or by calling their toll-free number, 1-877-479-7500. The Corporate Library's staff takes calls and assists with any questions, data corrections or comments. If requested, senior analysts will contact callers by phone or e-mail.

In addition, companies may ask to be notified when their ratings change. Board Analyst Ratings subscribers can create their own watchlists - and set-up an email alert system to keep them informed of such changes most easily.

D. Moody's Investors Service

1. Background
Late in 2002, Moody's Investors Service hired Ken Bertsch to be Director of Corporate Governance, coming over from TIAA-CREF. This coincided with the decision to launch a corporate governance rating program.

For Moody's, the main motive is to bolster their core credit analysis as its target audience is buyers of bonds, rather than buyers of stocks or proxy voters. As a result, Moody's does not offer a separate product. Instead, corporate governance is considered when a company's debt is rated for creditworthiness.

2. Calculation of Ratings
* **Which Companies** – Moody's main focus is on investment-grade and large companies.
* **Scoring System** – None, as its considered in the normal course as part of the credit rating of debt.

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* **Topics** – Moody's is still in the process of developing its criteria. These criteria act as screens for its analysts to look for red-flags. Due to the focus on debt, the criteria fall into two categories: financial statements and corporate governance.

Moody's analysts include accountants who thoroughly pour over a company's financial statements to look for risks, such as derivatives and other off-balance sheet items. Regarding corporate governance, the focus tends to be on the integrity of the financial preparation process, including auditor independence and audit committee strength. However, Moody's also takes into consideration other corporate governance issues, such as takeover defenses and shareholder rights.

3. Corporate Input into Ratings
Moody's relies on publicly available information, rather than on corporate input. Moody's may decide to purchase research from other providers.

4. How Often are Ratings Calculated
Whenever a company's debt is rated for creditworthiness.

5. How a Company Can Ascertain its Rating
Not really applicable as corporate governance is not a separate score.

E. Standard & Poors (http://www.governance.standardandpoors.com/)

1. Background
S&P's began the development of the criteria and methodology for its standalone Corporate Governance Score ("CGS") in 1998. Following two years of research, S&P started assessing companies' globally in 2000. The U.S. operation commenced in October 2002.

The focus of the score is to evaluate the company's corporate governance practices and policies to determine the extent to which these serve the interests of the company's financial stakeholders, with a particular emphasis on shareholders' interests. The criteria are globally applicable - and scores are globally comparable.

Companies pay S&P if they decide they want to be rated. The cost of a CGS typically ranges from $50,000 to $150,000 depending upon the size and complexity of the company.

2. Calculation of Ratings
* **Which Companies** – Any company can apply for a CGS.
* **Scoring System** – S&P ranks companies on a 1 (lowest) to 10 (highest) score basis.
* **Topics** – The four individual components that contribute to the overall CGS are:
* Ownership and stakeholder influence
* Shareholder rights and stakeholder relations
* Transparency and disclosure
* Board structure and process.

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The process involves analysts from S&P's Corporate Governance Services analyzing both public and confidential information from the company plus meetings with the senior executives, directors, auditors and potentially others. Following this diligence process, S&P prepares a detailed report covering the main elements of the analysis (key strengths & weaknesses), the individual scores for each of the four components, and the overall score.

Due to the fact that the S&P process is interactive and requires access to confidential information, they allow the company to withhold publication of the report. In this case, the company can use the diagnostic within the report as a road-map to improve its governance.

3. Corporate Input into Ratings
S&P's approach is fully interactive and therefore the company has significant input into the analytical process. However, the opinions contained within the CGS are arrived at independently and are S&P's alone.

4. How Often are Ratings Calculated
Once a CGS has been published, S&P monitors the company's corporate governance policies and practices on an ongoing basis. A full review is conducted annually.

5. How a Company Can Ascertain its Rating
As companies pay to be rated, they automatically get access to their score. In fact, they can elect for S&P not to make its score publicly available. If a company agrees for its score to be published, S&P ratings are freely available on its website.

As of March 2003, some 50 companies have been assessed by S&P globally and some 12 companies have published the results – including Fannie Mae.

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CORPORATE ACCOUNTABILITY

REPORT

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DIRECTOR LIABILITY

Seismic Rumblings in Delaware: The Shifting Terrain of Director Liability—Expanding the Concept of Good Faith, Tightening the Definition of Independence

BY MICHAEL J. HALLORAN AND ELISA LOWY

I. Introduction

With the fall of corporations such as Enron and WorldCom, and the highly publicized acts of misconduct at these companies, the public and shareholders have gained a heightened awareness of the role and duties of directors. Some commentators have felt that this heightened awareness is bringing a "perceptible shift in the rigor with which the courts will view director's conduct."[1] Preliminary indications of this shift were evidenced in the comments of Chief Justice Norman E. Veasey of the Delaware Supreme Court in a roundtable discussion focusing on executive compensation (the "Roundtable"),[2] Vice Chancellor Leo E. Strine's article "Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle"[3] and in a string of five cases decided "post-Enron," in which the Delaware Supreme Court consistently sided with the shareholders and against the corporate boards. The fact that these decisions were factually and procedurally diverse previously made it difficult to state with certainty that director conduct would be subject to more rigorous standards of judicial review. However, the trend is now confirmed with the Delaware Chancery Court's recent issuance of three more decisions, *Biondi v. HealthSouth*, [4]*In re Oracle Corp. Derivative Litigation*, [5] and *In re The Walt Disney Company Derivative Litigation*.[6] These three decisions vigorously administer the guidance found in the Supreme Court's five earlier decisions and, in effect, both Chief Justice Veasey's comments at the Roundtable and

[1] *Director Liability Warnings from Delaware*, Weil, Gotshal & Manges LLP, Jan. 10, 2003; *See also*, McGarry, *Director Liability: Dawn of a New Era?*, 7 M&A Lawyer 1 (May 2003).

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[2] Charles Elson, *What's Wrong with Executive Compensation? A Roundtable Moderated by Charles Elson*, January 1, 2003 Harv. Bus. Rev. 68 (referred to herein as the "Roundtable").

[3] 57 Bus. Law. 1371 (Aug. 2002).

[4] *Biondi v. Scrushy and HealthSouth Corporation*, 820 A.2d 1148 (Del. Ch. 2003).

[5] 824 A.2d 917 (Del.Ch.) Jun. 13, 2003.

[6] 825 A.2d 275 (Del.Ch.) May 28, 2003.

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Vice Chancellor Strine's statements in his article. It is important to note that while the Sarbanes-Oxley Act[7] and the exchange proposals[8] apply to public companies, these current developments in Delaware case law and Chief Justice Veasey's comments can be equally applicable to private companies.

II. The Expanding Definition of Good Faith, Narrowing Definition of Director Independence, and Rising Role of Voluntary Codes of Corporate Governance Best Practices

A. Chief Justice Veasey's Comments. During the Roundtable discussion, Chief Justice Norman E. Veasey suggested that in the post-Enron era, courts will be viewing director conduct with less tolerance. Chief Justice Veasey was asked whether directors should be looking to the courts for guidance on issues of executive compensation. He responded: "I do think the changes in corporate governance that we're seeing through the voluntary best practices initiative, for example, [i.e., voluntary initiatives which corporations have been implementing on their own] or through the New York Stock Exchange listing requirements have created *a new set of expectations for directors. And that is changing how courts look at these issues*."[9] As a particular example, he referred to "the Disney case" discussed below: "[W]e felt there could have been something in it [the complaint by the shareholders over the large termination settlement for Michael Ovitz]. In particular, [we questioned whether] Disney's board *act[ed] in good faith* in agreeing to Mr. Ovitz's compensation. Although the company had retained an outside expert, that expert later admitted that the board had never looked at what it would cost to buy Mr. Ovitz out."[10]

The moderator, Professor Charles Elson, commented: "That sounds like a fairly dramatic expansion of the good-faith concept. . .how would [the Delaware Supreme Court] determine whether or not a board was acting independently?"[11] Independence, of course, is a condition under Delaware law to directors' use of the business judgment rule as a defense to liability.[12] Conceding that the court cannot set down rules for independence, Chief Justice Veasey urged a common sense approach stating, "[W]e [the Court] didn't just fall off the turnip truck. . .[w]e can tell whether someone is acting independently or not."[13] For example, he stated that lawyers who are serving as directors on their client's boards, from whom they also receive substantial legal fees, generally cannot be considered independent. Moreover, he stated that if a director claims to be independent by basing decisions on certain information or processes, the director must actually rely on the information or processes *or there could be a breach of the director's fiduciary duty of good faith*.[14] As an example, Chief Justice Veasey suggested that compensation committees "have their own advisers and lawyers,"[15] and urged directors "to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively . . . *as a guard against anything that might happen to them in court from a properly presented complaint*."[16] Notably, he comments, "[d]irectors who are supposed to be independent should have the guts to be a pain in the neck and act independently."[17]

B. *Brehm v. Eisner*: *Setting the Stage for Expanding the Definition of Good Faith.* During the Roundtable, Chief Justice Veasey referred to the Delaware Supreme Court's decision in *Brehm v. Eisner*,[18] a decision which he authored, in his discussion of the standard of good faith. In *Brehm*, the shareholders of Disney brought a derivative suit alleging breach of fiduciary duty and nondisclosure claims against directors. The case involved an employment agreement between Disney and Michael Ovitz relating to Ovitz's brief tenure as president of the company. The employment agreement was quite lucrative, and in fact required Disney to pay more to Ovitz if he was terminated without cause than if he was to serve until the agreement's natural expiration.

The plaintiff-shareholders made several claims against Disney's board, including the claim that the board breached its duty of care in evaluating Ovitz's employment agreement. Although the court found that the complaint did not adequately plead this allegation, it did believe that a potential claim could have existed (if properly pled).[19] The board argued that, since it relied on a compensation expert to advise them on the appropriateness of the employment, they were protected by the safe harbor offered under Section 141(e) of the Delaware General Corporation Law.[20] In its decision, the court stated that the safe harbor would not be available if the directors *did not act in good faith* when relying on the compensation expert. The court (Chief Justice Veasey speaking) then proceeded to list examples of how the board may have breached its fiduciary duty

[7] Sarbanes-Oxley Act of 2002, Public Company Accounting Reform and Corporate Responsibility, United States Code Title 15, Chapter 98

[8] *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance*, 68 Fed.Reg. 19,051, 19,053 (Apr. 17, 2003); Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, 68 Fed.Reg. 14,451, 14,452 (Mar. 25, 2003).

[9] *Elson*, Harv. Bus. Rev. at 76 (emphasis added). *See*, Halloran, Lowy and Gurka, *Another Growing Trend in Corporate Governance Best Practices: Separation of the Positions of Chairman and Chief Executive Officer*, 7 M&A Lawyer 18.

[10] *Id.*

[11] *Id.*

[12] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[13] *Id.*

[14] *Id.* (Emphasis added).

[15] *Id.* (Emphasis added).

[16] *Id.* (Emphasis added).

[17] *Id.*

[18] 746 A.2d 244 (Del. Supr. 2000)

[19] The case, *In re Walt Disney Company Derivative Litigation,* discussed in detail below, and referred to herein as "*Disney II*," is a continuation of the *Brehm* litigation.

[20] Delaware General Corporation Law (Delaware Code 1953 as amended) Section 141(e). This section states, in relevant part, that: "a member of the board of directors . . . shall . . . be fully protected in relying in good faith upon . . . such . . . reports . . . by any . . . person as to matters the member reasonably believes are within such . . . person's . . . expert competence and who has been selected with reasonable care . . . on behalf of the corporation."

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of good faith. Some of the examples included facts tending to show that the board did not actually rely on the expert, that it did not rely on the expert in good faith, and that the subject matter (the cost calculation for terminating Ovitz's agreement) "was so obvious that the Board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice."[21]

As stated above, during the Roundtable, the fact that the board in *Brehm* "had never looked at what it would cost to buy Mr. Ovitz out," and that this failure could be used to find that the board lacked good faith, was noted by Professor Charles Elson as "a fairly dramatic expansion of the good-faith concept."[22] In his article, Vice Chancellor Strine also provided arguments to be used to expand the definition of the fiduciary duty of good faith. He anticipated plaintiffs making claims arguing that directors had specific duties which they were required to discharge, and that fulfilling these duties would require a director to devote a minimum amount of time reviewing documents and attending meetings. Plaintiffs, Vice Chancellor Strine expected, would compare the amount of time directors actually spent working as directors to the scope of their directorial responsibilities, and argue that directors who did not devote the time necessary to do their job had to know that they were not spending enough time fulfilling their directorial responsibilities. The result of a board member not spending an adequate amount of time attending to his duties as a director would, he said, arguably be a breach of the director's duty of good faith.

The effect of expanding the duty of good faith would have two critical consequences. The first would be to erode the protection afforded directors under the business judgment rule. Historically, absent evidence of fraud, bad faith, or self dealing, the business judgment rule would create "a presumption that, in making a business decision, the directors of a corporation acted on an informed basis[,] . . . in good faith and in the honest belief that the action taken was in the best interest of the company."[23] In order to rebut the presumption, the plaintiff would need to introduce "evidence either of director self-interest, if no self-dealing, or that the directors either lacked good faith or failed to exercise due care. . . ."[24] If the plaintiff fails to rebut the presumption, "the business judgment rule . . . will attach to protect the directors and the decisions they make."[25] The second would be to eliminate the protection on limitation of liability for monetary damages afforded under Section 102(b)(7) of the Delaware General Corporation Law,[26] and to prevent the corporation from indemnifying the director for damages personally incurred as a result of the director's actions.[27] While this statute normally limits a director's personal liability for acts that the director takes as a board member, this limitation is inapplicable if the director's action is not taken in good faith.

Given Chief Justice Veasey's comments during the Roundtable, Vice Chancellor Strine's article, and the current political climate evidenced by the passage of the Sarbanes-Oxley Act, directors would be wise to view *Brehm* as having established a higher standard for evaluating their conduct in light of an expanded "good faith" standard, one which is likely to enjoy renewed importance in the post-Enron environment.

C. The Question of Independence. As with good faith, a lack of independence will rebut the presumption that the protection of the business judgment rule should attach to a director's decisions and actions.[28] The question of what characteristics define an independent director has not been an easy one to answer. Historically, the Delaware courts have limited the factors which would impact a director's independence to those factors which would provide a direct and significant economic benefit to a director.[29] However, the Delaware courts have also been somewhat inconsistent with this approach.[30] In his article, Vice Chancellor Strine questions the wisdom of excluding non-economic relationships, such as friendships, from considerations of independence, as well as excluding those economic ties that do not result in a correlative increase in the director's personal wealth, and, in contrast to the majority of Delaware cases decided pre-Enron, suggests that a more critical inquiry is now appropriate when evaluating the ties between a director and the company, or a director and its officers:

"Why should the law presume that an outside director can impartially decide to sue his long-standing personal friend, the CEO? Why should the law presume that rational, outside directors enter into economic contracts with the corporation—such as consulting arrangements—that are immaterial to themselves? Why should the law presume that a director who is also the head of a charity receiving charitable contributions directed largely by corporate management, will not fear that such contributions would be reduced if he acts contrary to management's wishes? What, they will ask, is the empirical basis for the inference that such factors do not weigh on the minds of outside directors asked to challenge or even sue management?"[31]

The Delaware courts have not always been consistent when determining what factors bear on a directors' independence, and the questions listed above have been

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[21] *Brehm*, 746 A.2d at 262.

[22] *Id.*

[23] *Citron v. Fairchild Camera and Instrument Corporation*, 569 A.2d 53 at 64 (Del. Supr. 1989).

[24] *Id.*

[25] *Id.*

[26] Section 102(b)(7) of the Delaware General Corporation Law allows a corporation to include a provision in its certificate of incorporation "eliminating or limiting the personal liability of a director to the corporation or its stockholders for breach of fiduciary duty . . ." but this limitation of liability would not apply if there was a breach of the duty of good faith.

[27] Section 145 of the Delaware General Corporation Law permits corporations to indemnify its directors, but only if the director "acted, in good faith, for a purpose which he reasonably believed to be in . . . the best interests of the corporation."

[28] *Supra* footnote 12.

[29] *Strine* at 1378, citing *Crescent/Mach I Partners L.P. v. Turner*, No. 17455, 2000 WL 1481002, at 11 (Del. Ch. Sept. 29, 2000).

[30] *Id.* at 1379: "The cases, however, evidence a see-saw pattern. . . . For every two decisions that display a more optimistic belief in human nature and its implications for director independence, at lest one involves a more searching examination of relationships and economic arrangements that could arguably generate bias."

[31] *Id.* at 1382.

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considered by the courts previously.[32] However, decisions which considered these factors were in the minority.[33] As will be discussed below, these less-accepted lines of inquiry pre-Enron have, post-Enron, become the new independence standard.

III. Recent Delaware Court Rulings

A. Preliminary Indications. More than 50 percent of all publicly traded U.S. companies are incorporated in the state of Delaware.[34] In the post-Enron era, Delaware courts have frequently held in favor of shareholders. The Delaware Supreme Court issued written decisions in at least five post-Enron cases involving the performance of directors and their fiduciary duties and which have held for the shareholders and against the directors.[35] Following the Delaware Supreme Court, the lower Delaware Chancery Court has now, in several recent cases involving director conduct, including *HealthSouth*,[36] *Oracle*[37] and *Disney II*, [38]also found for the shareholders.[39]

B. *HealthSouth, Oracle* and *Disney II*: A Decisive Shift in Analyzing Independence and the Duty of Good Faith. The Delaware Supreme Court's five earlier decisions signaled a shift in the level of judicial scrutiny to be applied to director conduct. The more recent Delaware Chancery Court decisions in *HealthSouth*,[40] *Oracle*[41] and *Disney II*,[42] two of which, *HealthSouth* and *Oracle*, were written by Vice Chancellor Leo E. Strine, Jr., confirm this shift.[43]

1. *The HealthSouth Decision*. In *HealthSouth*, plaintiff-shareholders filed a derivative action against HealthSouth and its directors, including the chairman and then-CEO Richard Scrushy.[44] The board of directors appointed a special litigation committee (an ''SLC'') to investigate the shareholders' allegations of their wrongdoing. Normally, appointment of an SLC would be grounds to stay pending derivative litigation so that the SLC has time to investigate whether the derivative action should be prosecuted,[45] and the HealthSouth SLC moved to stay the pending litigation so that it could complete its investigation.[46] Prior to determining whether to defer to an SLC's decision to terminate derivative litigation, the reviewing court would examine both the ''independence and good faith of the committee and the bases supporting its conclusions.''[47] This inquiry would ordinarily wait until the SLC had completed its investigation. However, at the plaintiffs' behest, the Chancery Court examined the composition and actions of the SLC before the SLC completed its investigation.

Included among the facts reviewed by the court was the relationship between the two initial SLC directors and Scrushy. The court found that the two SLC directors had made large charitable donations to a sports organization of which both of the SLC directors and Scrushy served on the board of directors (one of the SLC directors was the organization's chairman),[48] that Scrushy and one of the directors had ''long-standing personal ties,''[49] and that Scrushy and one of the direc-

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[32] *Id*. at 1379, citing *In re Walt Disney Derivative Litig.*, 731, A.2d 342, at 358 n. 18 (sub-citation omitted); *In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986);

[33] *Supra* footnote 30.

[34] www.state.de.us/corp/index.htm.

[35] See *Telxon Corporation v. Meyerson*, 802 A.2d 257 (Del. Supr. 2002) (Reversing a summary judgment motion holding that triable issues of fact existed as to whether directors breached their fiduciary duty, and whether the prior CEO usurped a corporate opportunity, by approving the acquisition of a company founded by Telxon's former CEO.); *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. Supr. 2002) (Reversing a decision limiting access to books and records by stockholders who alleged wrongdoing by the company and its board of directors); *Levco Alternative Fund and Purchase LLP v. The Readers Digest Association, Inc.*, 803 A.2d 428 (Del. Supr. 2002) (Reversing denial of motion for preliminary injunction to stop a recapitalization because the board of directors did not fully and fairly evaluate the impact of the recapitalization on all classes of stockholders.); *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. Supr. 2003) (Reversing judgment dismissing complaint alleging that directors breached their fiduciary duty by increasing the size of the board as a defensive measure against a takeover proposal.); *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del.Supr. 2003) (unpublished decision) (Reversed a denial of a preliminary injunction to stop a merger transaction where the complaint alleged that directors breached their fiduciary duty by approving voting agreements, in the absence of a fiduciary out clause, thereby locking up the merger.); A sixth case, *Gotham Partners LP v. Halwood Realty Partners*, 817 A.2d 160 (Del.Supr. 2002) addresses the fiduciary obligations which a general partner holds to limited partners, and applies corporate fiduciary principles to find in favor of the limited partner and against the general partner.

[36] *Supra* at 1.

[37] *Id*.

[38] *Id*.

[39] Additional cases include: *In re National Auto Credit Inc Shareholders Litigation*, 2003 WL 139768 (Del. Supr. 2003); *Alidina et al. v. Internet.com Corp. et al.*, 2002 WL 31584292 (Del. Supr. 2002); *Parfi Holding AB et al. v. Mirror Image Internet Inc.*, 817 A.2d 149 (Del. 2002); *Goldman v. Pogo.com Inc.* 2002 WL 1358760 (Del. Supr. 2002), which is discussed below.

[40] *Supra* at 1.

[41] *Id*.

[42] *Id*.

[43] Some have interpreted this shift as not actually modifying the ''fundamental principles governing independent director liability.'' Lipton and Rowe memorandum, *The Business Judgment Rule Is Alive and Well*, Jun. 17, 2003, which discusses the impact of *Disney II* and *Abbott Laboratories Derivative Litigation*, 325 F.3d 795 (7th Cir. Mar. 28, 2003). While we agree with the authors of this article that diligence and care in discharging their duties will afford directors protection under the business judgment rule, we also believe that, in addition to heightened scrutiny of board action, the standards of what constitutes appropriate diligence and care have indeed changed; in short, directors must now work harder to meet the standards of good faith.

[44] Specifically, the directors were alleged to have sold large blocks of stock while knowing that the company's projected earnings were inflated significantly above what the company was actually expected to earn. After the directors made millions of dollars selling stock based on the false earnings projections, this material information was made public, and HealthSouth's stock price ''dropped nearly 50%'' See *Biondi* at 1151-1152.

[45] *Id* at 1149.

[46] *Id*.

[47] *Id*. at 1164, citing *Zapata v. Maldonado*, 430 A.2d 779 at 788 (Del. Supr.1981). Specifically, ''the court may defer to the committee's recommendation to terminate so long as that committee proves that its members: (1) were independent; (2) acted in good faith; and (3) had a reasonable basis for their conclusions.'' *Id.* at 788-89.

[48] *Id*. At 1157.

[49] *Id*.

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tors even had a stadium named after them.[50] The *HealthSouth* court found that this relationship was indicative of a lack of independence, but that these facts alone would not have been enough to have prevented the SLC from obtaining their requested stay of the derivative litigation (although it was enough to call their ultimate findings into question, and would have been deserving of further attention when the SLC had presented their findings).[51] Continuing its analysis, the *HealthSouth* court looked at the SLC's conduct when discharging its duties, and found several instances of conduct inconsistent with independence, the most notable of which was HealthSouth's issuance of a press release, just after the SLC began its investigation, in which the chairman of the SLC was quoted as stating that Scrushy ''had no inkling or knowledge'' of the alleged wrongdoing.[52]

As a result of the HealthSouth SLC's composition and actions, the court found that the SLC ''could not meet its burden to prove independence'' and that the ''HealthSouth SLC's early days involved several confidence-shaking events.''[53] In its holding, the court states: ''How can the court and the company's stockholders reasonably repose confidence in an SLC whose Chairman has publicly and prematurely issued statements exculpating one of the key company insiders whose conduct is supposed to be impartially investigated by the SLC? The answer is that they cannot.''[54] The *HealthSouth* court, thus, denied the SLC's motion to stay the derivative action.

Vice Chancellor Strine's article[55] addresses several of the tensions inherent in evaluating director conduct, including balancing close judicial review against the need to trust directors with the authority to manage the companies upon whose boards they serve. In his article, Vice Chancellor Strine anticipates that, in the wake of Enron, when plaintiffs call directors' independence and good faith into question, the judiciary will apply a more rigorous analysis of their independence and conduct.[56] This more rigorous analysis is evident in the *HealthSouth* court's detailed inquiry, an inquiry which is also consistent with that which Chief Justice Veasey proposed in *Brehm*, when he listed several pointed questions which could be used to test the Disney board's good faith in relying on an expert and, thus, whether the statutory safe harbor should be upheld to protect the directors' conduct.[57] The *HealthSouth* court also carefully analyzed the directors' behavior by measuring the SLC directors' conduct against the responsibility they were charged with—investigating the allegations against Scrushy and other board members. The court concluded that the conduct revealed by this analysis demonstrated a lack of independence, but it was also conduct which could have been used to demonstrate that the HealthSouth SLC had breached its fiduciary duty of good faith; among other actions, the SLC chairman's announcement that Scrushy should, in effect, be cleared of wrongdoing barely after commencing, let alone completing, their investigation could indicate that the SLC did not intend to conduct a bona fide investigation into the allegations against Scrushy.

While the HealthSouth situation, resulting in thirteen guilty pleas from management to date, has been added to the list of post-Enron scandals, the increased level of scrutiny applied by the Delaware courts can be observed in significantly less notorious circumstances and in the context of a privately held company. An example is the recent Delaware Chancery Court decision focusing on director independence, *Goldman v. Pogo.com*.[58] In this case, the plaintiff, who founded a company in 1991 that later merged with another company in 1995 (becoming Pogo.com),[59] had his equity position substantially diluted through a series of ''down-round'' bridge financings occurring in 1997 and 1998. The dilution of the plaintiff's equity position from 13.2 percent to 0.1 percent[60] benefited the bridge investors, which included the venture capital firm Kleiner Perkins Caufield & Byers (''Kleiner Perkins'').[61] The *Pogo* decision resulted from the defendants' motion to dismiss the plaintiffs complaint for failure to state a cause of action,[62] with the defendants asserting, in relevant part, that the business judgment rule protected the directors' decisions to approve the bridge financings and a subsequent reverse stock split[63] (which triggered the dilutive effect of the bridge financings).[64] The court concluded that, [65] since one of Pogo.com's directors had previously served on the board of directors of at least two other portfolio companies of Kleiner Perkins, and that Kleiner Perkins allegedly used this director as a short-term high-ranking executive in other Kleiner Perkins portfolio companies, there was a reasonable doubt as to whether the director was independent.[66] Using a similar analysis, the court found that several other Pogo.com directors also had ties with bridge investors which cast significant doubt on their independence.[67] As a result, the court denied the defendants' motion to dismiss with respect to several of the plaintiff's claims of breach of fiduciary duty, finding that the plaintiff had rebutted the presumption that the business judgment rule attached to protect these actions.[68]

2. The Oracle Decision. In this case, the court, with Vice Chancellor Strine authoring the decision, applied

[50] *Id.*
[51] *Id.* at 1165.
[52] *Id.* at 1158.
[53] *Id.* at 1156.
[54] *Id* at 1166.
[55] *Supra* at footnote 3.
[56] *Id* at 1373.
[57] *Supra* at page 4 and footnote 20.

[58] 2002 WL 1358760 (Del.Ch. 2002) (unpublished opinion)
[59] *Id.* at 1.
[60] *Id.* at 2.
[61] *Id.*
[62] *Id.* at 4.
[63] *Id.* at 3.
[64] *Id.* at 2.
[65] In coming to its conclusion, the court assumes that the facts pled in the plaintiff's complaint are true; in other words, the court's conclusion is not itself a finding that the facts alleged by the plaintiff are true, but that the law, if applied to these facts, has a particular result. However, in the context of shareholder derivative litigation, when a plaintiff's complaint survives a defendant-director's motion to dismiss, it has a significant effect on the direction the case takes thereafter. Surviving a motion to dismiss means that there is a greater likelihood that, unless the claims are settled, or an SLC is formed and successfully recommends dismissal, there will be a full trial on the merits; each of these alternatives in turn would result in substantial expense to the corporation as well as personal liability exposure for the defendant-directors.
[66] *Id.* at 5.
[67] *Id.* at 4 through 7.
[68] *Id.* at 8.

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a stringent analysis to the question of director independence. The *Oracle* litigation is based on allegations of insider trading lodged against Oracle's chairman and chief executive officer, Larry Ellison, and directors Donald Lucas and Michael Boskin (the ''Trading Defendants''). The *Oracle* court found that the two members of the SLC appointed to investigate the allegations of insider trading were not independent because there was a '' 'thickness' of the social and institutional connections among Oracle, the Trading Defendants, Stanford (University) and the SLC.''[69] The *Oracle* court reached this conclusion on the basis of several facts, discussed below, which the plaintiffs developed during the discovery proceedings pertaining to the court's evaluation of the SLC's investigative report on the insider trading allegations (the ''Report'').

The *Oracle* court used a recent analysis of independence in coming to its conclusion, invoking a Delaware Supreme Court Case, *Parfi Holding AB v. Mirror Image Internet, Inc*, which states:

At bottom, the question of independence turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity.[70]

There are many facts that the court found relevant to the determination of the SLC members' independence, all of which form a nexus between the SLC, the Trading Defendants, Oracle, and Stanford University. A summary of these facts follows:

- The SLC was comprised of two well-known Stanford professors, Hector Garcia-Molina and Joseph Grundfest, both of whom also obtained degrees at Stanford.[71] One of the Trading Defendants, Michael Boskin, is also a Stanford professor.[72] Boskin was also one of Grundfest's professors, and the two have remained in contact.[73] Boskin and Grundfest are also both senior fellows and steering committee members of the Stanford Institute for Economic Policy Research (''SIEPR'').[74]
- Trading Defendant Lucas is also a Stanford Alumnus,[75] and has contributed millions of dollars to Stanford, both indirectly, through a foundation of which Lucas is the chairman, and also directly.[76] Of his direct contributions, Lucas donated $424,000 to SIEPR and $149,000 to the Stanford Law School,[77] where Grundfest teaches. Lucas is also the chair of SIEPR's advisory board, and SIEPR's conference center is named after him.[78]
- Trading Defendant Ellison was found to have several financial ties to Stanford. A foundation he established has contributed nearly $10 million to the university,[79] and the same year that the SLC members were asked to join the board, Ellison was considering establishing a $170 million scholarship program at Stanford.[80] There are also reports of his stating an intention to bequeath his $100 million home to Stanford.[81]
- Oracle donated over $300,000 to Stanford, and established an educational foundation naming Stanford the ''appointing authority'' of the foundation.[82]

After analyzing the impact of the relationship between the SLC, Stanford, the Trading Defendants and Oracle, the court concluded that the SLC had ''not met its burden to show the absence of a material factual question about its independence . . . because the ties . . . are so substantial that they cause reasonable doubt about the SLC's ability to impartially consider whether the Trading Defendants should face suit.''[83]

Although the SLC had several plausible reasons why these facts would not have, and did not, affect their independence, the court found that these facts raised a reasonable doubt as to the SLC's independence. The *Oracle* court's analysis is consistent with the *HealthSouth* court's statements regarding that SLC's independence. As discussed above, the *HealthSouth* court found that ties pertaining to sporting organizations, which in many respects were similar to the shared ties to Stanford, existed between the SLC members and defendant Scrushy which cast doubt on their independence.

Despite the *Oracle* court's conclusion regarding the independence of the SLC directors, the court made several statements intimating that the actual report prepared by the SLC was a well-executed, high-quality product, and that the SLC had, in fact, done an admirable and thorough job investigating the allegations of insider trading lodged against the Trading Defendants.[84]

The *Oracle* defendants have indicated that they intend to appeal this decision,[85] and it will be interesting to see how the Delaware Supreme Court, if given the opportunity, decides. If the Supreme Court agrees with the Chancery Court, this would be consistent with the other recent cases where the Delaware Supreme Court is appearing to impose higher standards on director conduct and independence.

It is clear that *Oracle*, *HealthSouth*, and *Pogo* establish a more stringent standard of director independence than that which was the norm in Delaware before the Enron debacle, and it is expected that this level of scrutiny will be the applicable standard against which future conduct is measured. And, it is important to note that the NYSE and Nasdaq proposed definitions for testing who is not an independent director cannot be relied upon as the exclusive tests of independence under Delaware law.[86] When directors make a determination

[69] *Oracle* at 936.
[70] *Id.* at 938, citing 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev'd in part on other grounds,* 817 A.2d 149 (Del. 2002), *cert. denied,* 123 S. Ct. 2076 (2003).
[71] *Id.* at 923 and 924.
[72] *Id* at 930.
[73] *Id* at 931.
[74] *Id.*
[75] *Id.* at 931.
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.* at 932.
[80] *Id.* at 933.
[81] *Id.* at 935.
[82] *Id.* at 933.
[83] *Id.* at 942.
[84] *See,* for example, the court's discussion on pages 924-929 of *Oracle*.
[85] Scannell and Lublin, *Judge Rules Special Oracle Panel Had Conflicts of Interest*, The Wall Street Journal, June 17, 2003.
[86] Under the Nasdaq and NYSE proposed rules, the following persons shall not be considered independent: 1) a director who receives payments in excess of $60,000 under Nasdaq rules and $100,000 under NYSE rules, other than for board service (with certain limited exceptions); 2) a director who is affiliated with or employed by the company's outside auditors;

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of independence under the general requirements of either of these two self-regulatory organizations,[87] they should take into account the more searching inquiry now required by Delaware law.

3. The Disney II Decision. After the *Brehm* decision, the plaintiffs conducted limited discovery and filed an amended complaint, with the defendants again responding with a motion to dismiss the complaint for failure to state a cause of action. The *Disney II* decision results from this motion.[88] In *Disney II*, the plaintiffs alleged that the defendant directors breached their fiduciary duties to Disney in that they ''failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders.''[89] Consequently, the plaintiffs sought to have the directors ''held personally liable to the corporation for a knowing or intentional lack of due care in the directors' decision-making process regarding Ovitz's employment and termination.''[90]

The allegations in *Brehm* and *Disney II* arise out of the same employment arrangement between Disney and Michael Ovitz, and the resulting severance payment to Ovitz of over $140 million.[91] Following the suggestions for further inquiry which Chief Justice Veasey gave the plaintiffs in *Brehm*,[92] and as a result of conducting additional discovery, the plaintiffs more clearly developed the board's involvement (or lack thereof) in Disney's decision to enter into, and then terminate, its employment agreement with Ovitz. In doing so, the plaintiffs were able to allege that the directors did not, in fact, rely on an expert in approving the agreement, an argument which, in the *Brehm* decision, Chief Justice Veasey had suggested the Plaintiffs consider making. The plaintiffs also alleged facts demonstrating that the directors took so little action or initiative in evaluating first the employment agreement and then Eisner's decision to terminate the agreement that, consistent with Vice Chancellor Strine's statements in his article, the plaintiffs were able to assert that the directors did next to nothing towards fulfilling their obligation to evaluate the employment agreement or its termination, and, thus, that a colorable claim that the directors had breached their fiduciary duty of good faith existed.

Both the approval of the agreement and its termination were done at the behest of Michael Eisner, Disney's chairman and CEO, and also Ovitz's ''close friend for over 25 years.''[93] Although the board initially objected to Eisner's unilateral decision to hire Ovitz, the record indicates that they did not follow up with any of their objections.[94] During the board meeting approving the agreement, they spent very little time reviewing the employment terms before approving the decision to hire Ovitz.[95] They also did not receive the actual agreement to review (and did not ask for a copy), but instead only had a rough, materially incomplete summary of the agreement terms.[96] While Eisner was at fault for failing to adequately inform the board of the agreement and its terms, the board failed to do anything to ensure that they obtained the appropriate information. Knowing that they didn't have the draft agreement, they approved it anyway.[97] In addition, the board didn't request any analysis of the agreement, either on it own terms or in comparison with other agreements in the entertainment industry, and they did not hire an expert to assist them in evaluating the agreement.[98] Two days later, the compensation committee met to consider the agreement, knowing that additional terms would be negotiated, yet without conditioning their approval on actually seeing those terms.[99] Immediately after the compensation committee met, the board reconvened and approved the agreement, according to the minutes with almost no discussion, review or inquiry as to its terms. Eisner was left to negotiate the final terms of the agreement.[100]

Ovitz ''was not a good second-in-command,''[101] and within the first year of his employment, he and Eisner began negotiating his departure.[102] The two of them came to a final decision without obtaining board approval, although board approval was required.[103] When the board learned of the decision, they took no action, raised no questions, and showed no concern regarding the termination or its terms.[104]

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3) a person who is an executive officer of a company where any of the executive officers of the listed company serve on the compensation committee. In addition, NYSE excludes from the definition of independence a director who is an executive officer or an employee of a company that accounts for at least 2 percent or $1 million, whichever is greater, of the listed company's consolidated gross revenues, or for which the listed company accounts for a least 2 percent or $1 million, whichever is greater, of such other company's consolidated gross revenues. Similarly, under Nasdaq a person who is a partner, controlling shareholder, or executive officer of a company to which the listed company made payments, or from which the listed company received payments, in excess of certain dollar amounts, is not considered independent. Nasdaq excludes from its definition of independence former employees of the listed company, and directors whose immediate family member, is or has been, an executive officer of the listed company. See *Federal Register*, Vol. 68, No. 57, March 25, 2003 at p. 14452; See also *Amendment No. 1 to the NYSE's Corporate Governance Rule Proposals*, http//www.nyse.com.

[87] Pursuant to the Nasdaq proposed rule, in addition to the requirements set forth in footnote 86, an ''Independent Director'' is a person ''other than . . . [an] individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.'' The NYSE proposed rule also includes the following: ''No director qualifies as ''independent'' unless the board of directors affirmatively determines that the director has no material relationship with the listed company . . . . '' *Id.*

[88] *See* discussion in fn. 65.

[89] *Disney II* at 278.

[90] *Id.*

[91] *Id.* at 279.

[92] *Supra* at pg. 4.

[93] *Id.* at 279.

[94] *Id.*

[95] *Id.* at 280.

[96] *Id.*

[97] *Id.*

[98] Again, this is one of the suggested lines of inquiry in *Brehm*. *Supra* at pg. 4. Although the complaint litigated in *Brehm* alleged that the board had hired an expert to evaluate the Ovitz agreement, after further discovery the plaintiffs determined that the board had hired the expert to evaluate Eisner's employment agreement, not Ovitz's.

[99] *Disney II* at 281.

[100] *Id.*

[101] *Id.* at 283.

[102] *Id.* at 284.

[103] ''According to the new complaint, Disney's bylaws required board approval for Ovitz's non-fault termination.'' *Id.* at 285.

[104] *Id.*

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Consistent with the dicta in *Brehm* and with Vice Chancellor Strine's comments regarding good faith in his article, Vice Chancellor Strine wrote that the Disney board's lack of attention to Ovitz's hiring and then termination constituted a breach of their *duty of good faith*, stating that the complaint:

"suggests that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may have not been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."[105]

The court thus concluded that the plaintiffs sufficiently alleged: "a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests" which, in turn, would result in the defendant directors' conduct falling "outside the protection of the business judgment rule." [106]

On this basis, the court held that demand—the requirement that plaintiffs first demand the directors themselves determine whether to bring suit—was excused, that the defendants' motion to dismiss was denied, and that the plaintiffs' allegations "support claims that fall *outside* the liability waiver provided under Disney's certificate of incorporation."[107]

IV. The Rising Role of Corporate Governance

At the same time that the interpretation of the duty of good faith is expanding, and the standards of independence are narrowing, there are indications that the role of improved corporate governance is becoming increasingly helpful for directors to establish that they are making their decisions in good faith, thereby assisting boards to continue operating under the shelter of the business judgment rule, and benefit from the statutorily permitted limitation of liability in the certificate of incorporation and permitted corporate indemnification.

In *Brehm*, the court stated, "[a]spirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability."[108]

Recent case law confirms that diligent and assertive board action is now the expected conduct for independent directors and a good way to show that one is, indeed, following procedures sincerely and effectively.

Chief Justice Veasey's recent statements at the Roundtable went further. At the Roundtable, Chief Justice Veasey suggested that good corporate governance practices should be followed to ". . .guard [directors] from anything that might happen to them from a properly pleaded complaint."[109] This statement indicates that a board which follows a voluntary code of corporate governance best practices may also be establishing procedures which will help them to defend allegations that they have breached their duty of good faith or that they have compromised their independence. Merely adopting corporate governance best practices should not, however, be viewed as a panacea. As Chief Justice Veasey stated during the Roundtable, one actually has to follow, "sincerely and effectively,"[110] the procedures adopted in order for them to be of value.

Recent case law confirms that diligent and assertive board action (e.g., "having the guts to be a pain in the neck," as Chief Justice Veasey suggested at the Roundtable) is now the expected conduct for independent directors and a good way to show that one is, indeed, following procedures sincerely and effectively. In *Creo, Inc. v. Printcafe Software, Inc.*,[111] Creo, a 30 percent shareholder of Printcafe, entered into share purchase agreements to acquire an additional 25 percent of the outstanding Printcafe shares for $1.30 per share, and then submitted a merger proposal pursuant to which it would acquire the remaining outstanding shares of Printcafe, also at $1.30 per share. Shortly thereafter, another company offered to acquire all of the outstanding Printcafe shares for $2.60 per share. Printcafe appointed a special committee to evaluate the competing proposals and negotiate with the bidders in order for the committee to maximize the value of Printcafe's shares. However, since Creo had the ability to close on the outstanding purchase contracts, and thereby gain control of the company and obtain the ability to force the merger to occur at $1.30 per share, the committee determined that it needed to take extraordinary measures in order to limit Creo's ability to force their

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[105] *Id.* at 289. These facts are consistent with the statement Vice Chancellor Strine made in his article: ". . . Enron and situations like it suggest to me that skillful plaintiffs' lawyers will begin making common-sense arguments about the disconnect between the routine tasks directors undertook to perform and the effort they put in to accomplish them." *Strine* at 1385. Later in the article, he continues: "(T)he integrity of the corporation law demands that directors be held accountable if they are clearly proceeding with the conscious knowledge of their own inadequacy in performance . . . . These corporations often engage in far-flung activities of a complex nature, which a mature person recognizes cannot be understood, let alone overseen, without substantial effort." *Id.* at 1393.

[106] *Id.*

[107] *Id.* at 290. This means that the directors can be held personally liable for monetary damages. *See, Supra* pages 4 and 5 and footnotes 26 and 27, which explain the limitation of liability issue in more detail.

[108] *Brehm,* 746 A. 2d at 256.

[109] *Id.*

[110] *Elson,* Harv. Bus. Rev. at 76.

[111] Del. Ch., C.A. 20164, Chandler, C. (Feb. 21, 2003), as cited in Wolfe and Salomone, *Pure Resources, Printcafe and the Pugnacious Special Committee, 7 M&A Lawyer 1 (May 2003)*.

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merger proposal and thus to maximize shareholder value. The committee approved a shareholders' rights plan which would have had the effect of preventing Creo from increasing the percentage of shares it owned in Printcafe. Creo sought to enjoin the adoption of the shareholder rights plan, alleging that the Printcafe board breached its fiduciary duties when it approved the plan. However, the *Printcafe* court disagreed with Creo, instead finding the Printcafe directors' actions to be commendable: "[The directors] were acting consistent with their obligations and fiduciary duties to achieve the highest and best value reasonably obtainable for the Printcafe shareholders if in fact the company is going to be sold."[112]

While we now have several examples of the Delaware courts determining that boards have not fulfilled the new, higher standards of conduct and independence, it is quite helpful to also have a recent decision that demonstrates director conduct of which the Delaware courts approve. *Printcafe* can be referred to for guidance of what Delaware courts are expecting to see in response to Chief Justice Veasey's suggestions that being an independent director may now require "having the guts to be a pain in the neck."

V. Conclusion

In the wake of Enron and similar unfortunate scandals, both the Delaware Supreme Court and Chancery Court have taken a tougher stance on director conduct, analyzing conduct under a variety of different, but fact-specific and penetrating common-sense inquiries into board dynamics and behavior. While the dicta in *Brehm* shows that there was some movement in this direction before Enron, recent comments from Chief Justice Veasey and Vice Chancellor Strine, combined with the five Delaware Supreme Court decisions and the Delaware Chancery Court's decisions in *HealthSouth*, *Oracle* and *Disney II* demonstrate that these scandals have catalyzed a decisive shift in the standards under which director independence and good faith will be evaluated, standards that will have a particularly important effect when used to assess whether a director has discharged his or her fiduciary duty of good faith. [113]

Directors should, thus, evaluate their actions under an expanded interpretation of the duty of good faith, and a more stringent interpretation of independence, when relying on the broad protection historically afforded them under the business judgment rule, and, with respect to good faith, the statutory limitations of liability and permitted corporate indemnification of directors.

Balancing out the greater scrutiny and expanded fiduciary duties is the apparent willingness of the court to consider a voluntary best practices code or other good corporate governance practices (but only if actually followed) as evidence of good faith, and as an appropriate method for individual companies to establish standards of independence that should apply to their directors prior to their independence being called into question. Thus, directors who work hard at their jobs, with a concerted effort to be diligent, inquiring and assertive—and, where independence is required, closely scrutinize their relationships and those of their fellow board members—will continue to be protected by the business judgment rule, statutory limitations of liability and indemnification. However, those who regard a directorship as a sinecure—like a club membership requiring participation and inquiry only when convenient—should reevaluate whether continued board service is in their and the company's best interests.

The law in Delaware appears to be focusing on a simple and necessary notion: directors should direct.[114] Direction requires that a director keep informed. It requires that he complain about it when he is not being adequately informed. It requires that she establish systems and controls designed to drive up information to the board regarding business performance and legal and other risks. These are notions embodied in the now-famous Delaware Chancery Court's *Caremark* decision,[115] and *Disney II* may also be taken as a reaffirmation of the duty of oversight (also referred to as the duty to monitor). Once the information is obtained, a duty of further inquiry arises where problems and issues become apparent. The Delaware courts and justices expect directors to be assertive in this regard. CEO- and management-"centric" governance of corporations, evident in a number of the recent corporate failures, should no longer be considered appropriate.

[112] *Id.*

[113] The response to Enron and other corporate failures has been to increase federalization of corporate governance and even corporate law as evidenced by the Sarbanes-Oxley Act and the many SEC rules adopted thereunder. The trend and changes in Delaware, assuming they continue, are a powerful argument against further federalization.

[114] Directors are advised to review *The Corporate Director's Guidebook* for additional suggestions for fulfilling their responsibilities. Corporate Laws Committee, ABA Section of Business Law, *The Corporate Director's Guidebook, Third Edition*, 2001; the 4th edition, which is expected to be published shortly, will address many of the post-Enron principles.

[115] *In re Caremark Derivative Litigation,* 698 A.2d 959 (1996).

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ANOTHER GROWING TREND IN CORPORATE GOVERNANCE BEST PRACTICES: SEPARATION OF THE POSITIONS OF CHAIRMAN AND CHIEF EXECUTIVE OFFICER*

May 20, 2003†

Recent corporate scandals have focused attention on corporate governance issues, one of which is the role of the Chief Executive Officer and his or her relationship with the board of directors. Currently, most major companies have CEOs who also hold the position of Chairman of the Board. However, in an effort to improve corporate governance practices, it has been suggested that companies split the roles to protect the flow of information to the Board and to ward against a potentially domineering CEO, which has been a perceived problem in several recent corporate failures.

The role of the Chairman is to control the flow of information to the board and set the agendas. However, it is in the CEO's best interest to present information to the board that reflects well on his or her financial performance. What is being done from a corporate governance standpoint to ameliorate this potential problem and endeavor to promote the flow of complete and unbiased information to the board?

Reports on Corporate Governance Best Practices in the United States and the United Kingdom

An influential report on corporate governance best practices, issued January 9, 2003, the Report of the Conference Board Commission on Public Trust and Private Enterprise ("Report of the Conference Board"),[1] recommends that the CEO and Chairman positions be split, with the position of Chairman filled by an independent director.[2] The Report of the Conference Board was presented by a blue ribbon commission comprised of several prominent figures in U.S. finance, co-chaired by Peter G. Peterson and John Snow, and also including Arthur Levitt, Paul Volker, Andrew S. Grove, John Bogle, Charles Bowsher, Peter Gilbert, Ralph Larsen, Lynn Sharp Paine and Warren Rudman. In the UK, splitting the positions is common practice, with approximately 90% of listed companies doing so. The Review of the Role and Effectiveness of Non-Executive Directors, issued January 2003, authored by well-known British investment banker Derek Higgs and commonly referred to as "The Higgs Report," [3] recommends that the

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[1] The Conference Board, Inc., *Commission on Public Trust and Private Enterprise; Findings and Recommendations*, Jan. 9, 2003.

[2] The Conference Board discusses two levels of independence with respect to the Chairman. The first level is a chairman who meets the technical requirements under the listed company's relevant stock exchange standard of independence. The second level is a chairman who may not meet the stock exchange standard of independence, but who "does not, in fact, have any relationships with the CEO or other members of management that compromises his or her ability to act free from the control of the CEO and management." *Report of the Conference Board* at 8.

[3] Higgs, Derek, *Review of the Role and Effectiveness of Non-Executive Directors*, Jan. 2003, The Stationary Office. Additional copies are available at: www.dti.gov.uk/cld/non_exec_review

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split remain in place, but adds that the Chairman should also be required to meet standards of independence.[4] The recommendations contained in the Higgs Report are expected to be incorporated into Britain's Combined Code of Practice,[5] with which all listed UK companies are required to comply or to explain the reasons for their non-compliance.

Recommendations on Board Structure – Preferences and Alternatives

Recommendations notwithstanding, both the Conference Board and the Higgs Report recognize that a "one size fits all" approach would not be appropriate. The Conference Board proposed three alternative board structures to balance the positions of CEO and Chairman. First, the Non-CEO Independent Chairman, which is its preferred approach to filling the two positions. The Conference Board provides two alternative, less preferred, structures. The first is for when the roles of Chairman and CEO would be performed by two separate individuals, but with a Chairman who isn't independent (as defined under applicable listing requirements). In this case, a "Lead Independent Director" would be appointed. The second alternative is for boards which do not separate the Chairman and CEO positions, or where they are in transition to such a separation. In this situation, a "Presiding Director" position would be established. The Conference Board defines the duties of the Non-CEO Independent Chairman, the Lead Independent Director and the Presiding Director as follows:

> The Non-CEO Independent Chairman (preferred approach) would be an independent director, and would preside at board meetings and at meetings of the non-management directors; have ultimate approval over information sent to the board; have ultimate approval over the board meeting agenda; serve as the principal liaison to the independent directors; and set meeting schedules to ensure that the independent directors have time for discussion of all agenda items.
>
> The Lead Independent Director (when the Chairman is a different person than the CEO, but not an independent director under stock exchange standards) would chair meetings of the non-management directors; serve as the principal liaison to the independent directors; and work with the non-CEO Chairman to finalize information flow to the board, meeting agendas, and meeting schedules.

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[4] The Higgs Report suggests the following as the definition of independence: "A non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director's judgment. Such relationships or circumstances would include where the director: is a former employee of the company or group until five years after employment, or any other material connection, has ended; has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company; has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme; has close family ties with any of the company's advisers, directors or senior employees; holds cross-directorships or has significant links with other directors through involvement in other companies or bodies; represents a significant shareholder; or has served on the board for more than ten years."

[5] *The Combined Code; Principles of Good Governance and Code of Best Practice*, Derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports, May 2000. Available at www.ecge.org/codes/country_pages/codes_uk.htm

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> The Presiding Director (when Chairman and CEO are the same person) would preside at executive sessions of the non-management directors; serve as the principal liaison to the independent directors; have ultimate approval over information sent to the board; have ultimate approval over the board meeting agenda; and set meeting schedules to assure that the directors have sufficient time for discussion of all agenda items.[6]

Note that the duties of the Presiding Director are the same as a Non-CEO Independent Chairman. The key difference between the roles of the Lead Independent Director and the Presiding Director would be one of authority, with the Presiding Director having ultimate control over the issues under his or her purview.

The Conference Board further recommended that if a board did not choose to adopt one of these alternatives they should disclose why and employ objectives of strong, independent board leadership.

The Higgs Report also recommends that the positions of Chairman and CEO be held by different individuals, and that the Chairman should, at the time of appointment, meet the Combined Code's test of independence. In addition, it is recommended that the Chairman not be a prior CEO of the same company. The Higgs Report also recommends that one-half of a company's board members be independent, excluding the Chairman, who is expected to lose his or her independent status during the course of serving as Chairman. Finally, the Higgs Report recommends that the board designate one Senior Independent Director, who would be available to shareholders should the chairman or CEO be an inappropriate or non-responsive contact. The Higgs Report does not provide alternatives to this structure, although it recognizes that different companies may choose to deviate from the recommendations.

Evidence of a Trend

The Report of the Conference Board and the Higgs Report were released in the midst of a climate of intense scrutiny of historical corporate governance practices, scrutiny which was provoked by the Enron, Worldcom, Tyco and other, disturbingly similar, scandals, most recently, Royal Ahold on the European scene. Much of the current focus on corporate governance is directed towards restoring investor confidence and preventing a repeat of Enron et al. Given the current intense focus on corporate governance, and the importance that good corporate governance has acquired in the public eye, we have undertaken to assess how "big business" has responded to public and investor pressures by trying to quantify the number of companies that have split their CEO and Chairman positions in reaction to these pressures. Our review focused on those companies listed on the S&P 500[7] and the Forbes 500.[8]

Most companies listed in the S&P 500 and the Forbes 500 currently have a Chairman who also holds the position of CEO. Almost 80% of S&P 500 companies currently combine the positions. In addition, of the 20% that do split the position, a lot of the Chairmen are still insiders, and

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[6] *Report of the Conference Board* at 22.

[7] www2.standardandPoor's.com/spf/xls/index/mktulat.issues.xls

[8] http://www.sfgate.com/cgi-bin/article.cgi?f=/business/pages/2002/chronicle200/charts/200.DTL

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many of the split positions are due to merger. However, an increasing number of companies, including for example Charles Schwab, Chubb and Tenet Healthcare, have recently decided to split the positions and have related the decisions directly to implementing best practices in corporate governance. We have also identified companies outside of the S&P 500 and Forbes 500, including E-Trade and Midas, that have recently split the positions. In addition, Silicon Valley Bancshares, listed on Nasdaq, recently appointed an independent Chairman.[9]

Some companies have been asked to defend their reasons for not splitting the positions. A notable example is Tyco, which in the wake of its former CEO's indictment and resignation, chose to have the positions combined. Their explanation was "that the board felt that having the two positions combined would allow the company to move faster and more efficiently"[10] in a crisis situation. Nonetheless, Tyco shareholders submitted a shareholder proposal that the positions be split, and in light of further recent accounting revelations, momentum on this proposal is likely to gather.[11] Many other companies have not offered adequate (based on public response) explanations of their failure to split the positions. AOL, for example, has been criticized for its failure to split the positions in light of its poor performance. There has also been a notable increase in the number of shareholder proposals requesting separation of the positions of Chairman and CEO. CFO.com has noted that 27 such resolutions have thus far been filed this year, where only 4 such proposals were submitted in 2002.[12] One of these proposed resolutions, filed by Robert Monks, a founder of Institutional Investor Services, states that separation of the positions of Chairman and CEO "will provide greater accountability of management to the shareholders, and provide more independent oversight of management, including the CEO, by the board of directors."[13] The Securities and Exchange Commission is allowing such share-holder proposals to be included in management proxy statements, and is not rejecting them under the "ordinary business" or other exceptions from inclusion in the SEC Rules.

We have identified a discernible trend towards splitting the Chairman and CEO positions, and we would not be surprised if more companies began to do this, if not on management's initiative then in response to pressure from their shareholders. Both the Higgs Report and the Conference

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[9] *Silicon Valley Bancshares Appoints Pete Hart Chairman*, April 17, 2003. Prior to Mr. Hart's appointment, the positions of CEO and Chairman were split, but the Chairman, John Dean, was a prior CEO of the company. svb.com/pr/index.asp?q2&d=041703a

[10] Ben White, S*ave the Chair for the Chief? There's Concern but No Consensus About CEOs Leading Boards*, Washington Post, Feb. 7, 2003.

[11] One of Tyco's institutional investors submitted a proposal that Tyco's bylaws be amended to require that the positions of CEO and Chairman be filled by separate individuals. Tyco requested a no-action letter from the SEC to authorize excluding the shareholder proposal from their proxy on the grounds that their Chairman and CEO, Edward Breen, is under contract with Tyco, and that the proposal, if adopted, would require Tyco to breach its contract with Mr. Breen. The SEC responded that the proposal would need to be included in the proxy, but that the bylaws provision requiring that separate individuals serve in the positions of Chairman and CEO would be subject to the company's existing contractual obligations. The proposal was defeated at the annual shareholders meeting by a vote of 33.1% for and 66.9% opposed. *Tyco Reports on Results of Annual Meetings*, March 6, 2003; http://www.tyco.com/commitment/gov_news_deetail.asp?prid=3. Tyco re-elected its lead independent director. *Newly Elected Tyco Board Makes Committee Assignments and Adopts New Initiatives to Enhance Corporate Governance*, March 7, 2003; tyco.com/commitment/gov_news_detail.asp?prid=1

[12] Stephen Taub, *Coming: Surge in Proxy Battles*, CFO.com, Feb. 18, 2003.

[13] *23 Proxy Resolutions Filed with ExxonMobil on Global Warming, CEO/Chair Separation, Other Issues*, Shareholder Action Network, Feb. 25, 2003.

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Board Report were released in January of this year, and, while there has been a lot of discussion regarding improved corporate governance over the last two years, these two reports are arguably the most influential and comprehensive studies to have been commissioned on the subject. Thus, it is quite possible that companies which are attuned to the recommendations contained in the reports are still in the process of adopting and implementing corporate governance best practices consistent with the recommendations. In support of this possibility, there are indications that a strong majority of directors favor a split. For example, McKinsey Corporation surveyed 180 U.S. directors representing 500 companies, and 70% felt that the roles should be divided. Moreover, 72% approved of the concept of appointing a Lead Independent Director.[14] However, regardless of what the boards ultimately decide on the matter, the shareholders, armed with their shareholder proposals, may have the last word. But it appears that there is another, perhaps even more effective, last word – the cost of capital.

The Emergence of Corporate Governance Ratings – Corporate Governance Expected to Affect Cost of Capital

If none of the above reports nor shareholder pressure generate such a response, another recent development which should push companies towards effecting a split is the emergence of corporate governance ratings. Until quite recently, corporate governance has been a "soft" concept, regarded by many as an area which would have little immediate quantifiable impact on a company's financial picture or its present cost of doing business as opposed to having beneficial long-term value for the corporation. While investors have previously indicated that they would pay more for the shares of a well-governed company,[15] until recently there have been very few methods of quantifying good governance and determining what this would actually be worth to an investor. However, Standard & Poor's,[16] Moody's[17] and other organizations[18] have begun rating U.S. companies on the quality of their corporate governance, which expressly

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[14] Inside the Boardroom, The McKinsey Quarterly.

[15] McKinsey & Company, "Investor Opinion Study," June 2000: "Over 80% of investors say they would be prepared to pay more for the shares of well-governed companies than those of poorly governed companies."; "Three-quarters of investors say board practices are at least as important to them as financial performance when they are evaluating companies for investment . . . ."

[16] Standard & Poor's offers a corporate governance score ("CGS"), which it describes as follows: "Using Standard & Poor's corporate governance criteria and methodology, a CGS focuses on what a company does, not on the minimum required by local laws and regulations – not just the form of a company's corporate governance but also its substance. A company invites Standard & Poor's to conduct the scoring process; the resulting score and report are based on interactive, independent research and are internationally comparable. Publication of the score is determined by the company assessed." standardandpoors.com/NASApp/cs/

[17] In a press release, Moody's stated: "Moody's will apply greater analytical focus and commit additional resources to its analysis and published research on the quality of financial accounting and the transparency of corporate disclosure, corporate governance issues, and risk management and derivatives issues related to credit." Moody's to Introduce Specialized Analytical Teams to Enhance Corporate Credit Analysis, June 13, 2002. ttp://ir.moodys.com/ireye/ir_site.zhtml

[18] Institutional Shareholder Services intends to include a corporate governance rating in its reports to shareholders. Charles Sisk, *Governance Ratings Plan in the Works,* The Daily Deal, Feb. 14, 2002. GovernanceMetrics, a company formed in April 2000, is specializing in ratings and research regarding corporate governance, with the intention of making the ratings available to the institutional investors and the investing public on a subscription basis. Phyllis Plitch, *GovernanceMetrics Debuts New Corporate Governance Ratings*, Dow Jones News Service, Dec. 3, 2002.

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includes for at least one organization the criterion of whether the positions of Chairman and CEO are split.[19] Moody's has stated that it will begin to include corporate governance criteria as a factor in its bond ratings,[20] and Standard & Poor's has likewise said as much, "noting that weak governance can undermine creditworthiness in several ways and should serve as a red flag to credit analysts."[21] Fitch Ratings also includes corporate governance as a factor in its ratings, and "is coming up with a range of governance structures that would support a strong debt rating."[22] CalPERS (the California Public Employees'Retirement Systems), which has long recommended that companies reconsider "the traditional combination of the 'chief executive' and 'chairman' positions,"[23] has recently released its annual corporate governance focus list. Out of the six companies included on the list,[24] CalPERS recommended that all but one split the positions of Chairman and CEO.[25] The SEC has also proposed that companies which are subject to the reporting requirements of the Securities Exchange Act of 1934 be required to file an 8-K disclosing changes to its credit rating.[26] According to CalPERS, "the 100 companies placed on the CalPERS focus list from 1992 to 2001 saw an average 12 percent excess gain in value in the three months following placement on the list."[27] A 2002 study released by McKinsey & Company "found that corporate governance is now an established investment criterion" and that "investors are willing to pay an average premium of 14 percent for the stock of well-governed

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[19] Institutional Shareholder Services specifically includes as one of its criteria whether the positions of Chairman and CEO are split. *Investment Community Skeptical About New Services That Measure Corporate Governance Quality; Gregory FCA Survey Finds Support for Increased Regulation*, Business Wire, Jan. 2, 2003. Standard & Poor's does not expressly state that splitting the positions is a requirement, but does consider this as a factor when evaluating board composition in its corporate governance evaluation. For example, in its review of Fannie Mae, Standard & Poor's noted the following: "In January 2003, the Fannie Mae board chose to establish a formal presiding director structure that Standard & Poor's believes could provide a counterbalance to the combined Chairman/CEO role. . . . We have seen evidence that this role is in practice similar to that of a lead director. Although the concentration of power in the combined Chairman/CEO position brings some positives as well, it warrants monitoring." Standard & Poor's Corporate Governance Score Evaluation of Fannie Mae, Jan. 30, 2003, available from Standard & Poor's.

[20] Moody's states that corporate governance comes up "most often at two critical points in the debt-rating process: when a company is first classified as 'investment grade,' or safe for the average investor; and when it is upgraded to Aaa, the top rating." Ben White, *Bond-Rating Firms Get into Governance; Analysts Assess Corporate Practices*, Washington Post, Feb. 15, 2003.

[21] *Agencies Focus on Folding Governance Changes into Corporate Ratings*, Corporate Financing Week, Sept. 29, 2002; Ken Schachter, *Credit Agencies Start Rating Corporate Governance*, Long Island Business News, Nov. 8, 2002; *Jack in the Box Inc. Receives High Ratings for Corporate Governance*, Business Wire, Feb. 11, 2003 ("S&P recently linked corporate governance to credit quality.").

[22] White, *Bond-Rating Firms Get into Governance*, *supra*.

[23] The California Public Employees' Retirement System, *Corporate Governance Core Principles & Guidelines*, April 13, 1998, pg. 9; calpers-governance.org/principles/domestic/us/page01.asp

[24] The six companies are: Xerox, Gemstar-TV Guide International Inc., JDS Uniphase Corp., Manugistics Group Inc., Midway Games Inc., and Parametric Technology.

[25] The one company for which this was not recommend, Gemstar-TV Guide International, Inc., has two different people filling the roles of CEO and Chairman. However, CalPERS noted as an area of concern that the Chairman is a prior CEO.

[26] *Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date (Release Nos. 33-8106; 34-46084)*. sec.gov/rules/proposed/33-8106.htm.

[27] *CalPERS Names Xerox, Others to Corporate Governance Focus List*, 35 Securities Regulation & Law Report 13, March 31, 2003.

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companies."[28] Thus, good corporate governance (or lack of it) will begin to have a direct and quantifiable effect on a company's business, specifically its cost of capital.[29] Although quantifying corporate governance as an actual business metric by rating agencies and other organizations is an emerging pursuit, we expect it to accelerate the pace at which companies develop and implement corporate governance best practices.

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[28] As quoted in *Jack in the Box Inc.*, *supra*.

[29] In addition to impacting its cost of capital, governance issues are directly impacting institutional investors' choices when evaluating an investment, and "some institutional investors are already incorporating . . . governance scores in the investment screening process." *Fleishman-Hillard and Georgeson Shareholder Launch Corporate Governance Intelligence (CGI)*, PR Newswire Association, Feb. 18, 2003.

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