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ATTORNEY-CLIENT PRIVILEGE

Is the Department of Justice's McNulty Memorandum a Cure-All?

By David Z. Seide

Increasing Government demands that corporations waive the attorney-client privilege, especially in criminal cases, have met with howls of protest. In apparent response, the Justice Department has recently appeared to back off, notably through the Memorandum Deputy Attorney Paul McNulty sent to federal prosecutors in mid-December 2006, although how far back the Government has actually retreated (if at all) is now debatable.

Our story begins with the now-infamous Thompson Memorandum. Issued by then-Deputy Attorney General Larry Thompson in 2003, the Memorandum was the first to specify factors that federal prosecutors were required to use when making charging decisions against corporations suspected of wrongdoing.¹ Two factors that became lightning rods for criticism were first, demands that corporations, to prove their cooperation, waive the attorney-client privilege and produce the results of their internal investigations, and second, that corporations deny

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payments of attorneys' fees to employees under investigation. The Securities and Exchange Commission promulgated a comparable document in 2002, through the Seaboard Report, which also suggests that corporations can demonstrate their cooperation by waiving the privilege.²

Such waiver demands have been criticized by a wide array of organizations and individuals, including the American Bar Association, the US Chamber of Commerce, the ACLU, former high-ranking Department of Justice officials, current SEC Commissioner Atkins, and a variety of commentators.³ Moreover, in two widely-reported published opinions in *United States v. Stein*, the case arising out of the pending criminal prosecution of former employees of the KPMG accounting firm for selling allegedly-illegal tax shelters, the district court declared unconstitutional that portion of the Thompson Memorandum which led government prosecutors to pressure KPMG not to pay the legal fees of these employees, contrary to KPMG's standard practice.⁴

The McNulty Memorandum

In the wake of this mounting criticism, the Government took notice. On December 12, 2006, Deputy Attorney General, Paul McNulty, issued a memorandum scaling back the more-controversial aspects of the Thompson Memorandum.⁵ In particular, and in apparent recognition that waiver demands by line-prosecutors have become commonplace, the McNulty Memorandum now requires prosecutors to obtain prior written senior supervisory approval—starting at the level of the United States Attorney and rising to the Deputy Attorney General—before making a waiver demand.

Notably, the McNulty Memorandum does not prohibit waiver demands from prosecutors, nor does it prevent corporations from demonstrating their cooperation through voluntary waivers of the privilege. Instead, it places hurdles in the path of prosecutors bent on making such demands. The Memorandum requires that prosecutors follow a two-step process before requesting that a corporation provide privileged information. First, in order for an Assistant United States Attorney (AUSA) to request from a corporation “purely factual information, which may or may not be privileged, related to the underlying conduct”—defined in the Memorandum as “Category I” information—the AUSA

must obtain prior written authorization from the local United States Attorney. The United States Attorney must in turn consult with the Assistant Attorney General for the Criminal Division at Main Justice in Washington before granting or denying the request. Second, and only if the Category I information “provides an incomplete basis to conduct a thorough investigation,” the local United States Attorney can request that a corporation produce “attorney-client communications or non-factual attorney work product”—“Category II” information—provided the Deputy Attorney General (the second-most senior official in the Justice Department) provides prior written approval.⁶

The Memorandum also goes on to direct prosecutors not to take into account for charging decision purposes a corporation's decision not to provide Category II information, although they can take into account the corporation's response to a Category I information request, and they can continue to make waiver demands in situations where corporations agree to plead guilty and cooperate with the government.

The McNulty Memorandum also curtails that portion of the Thompson Memorandum which penalized corporations that elected to pay the legal fees for employees under investigation. Under the McNulty Memorandum, such payments—which are typically authorized by state law and incorporated into the bylaws of most corporations—will “generally not [be] take[n] into account” as evidence of a lack of cooperation. In a footnote, the Memorandum provides that “[i]n extremely rare cases, the advancement of attorneys' fees may be taken into account when the totality of the circumstances show that it was intended to impede a criminal investigation.” But the Memorandum then limits the application of that exception by requiring that prosecutors first obtain prior approval from the Deputy Attorney General before they may consider the factor.

Proposed Legislation

The McNulty Memorandum was issued on the heels of legislation proposed in the Senate five days earlier, on December 7, 2006, by outgoing Senate Judiciary Chairman Arlen Specter. His bill, the Attorney-Client Privilege Protection Act, would outlaw, flat-out, the most questionable aspects of

the Thompson Memorandum.⁷ In particular, the bill would bar federal attorneys or agents engaged in criminal or civil enforcement matters from demanding or requesting that a corporation waive the attorney-client privilege, and from pressuring companies not to pay legal fees for individual employees.

The bill goes on to provide that nothing prevents a corporation from making and the government from accepting a voluntary production of internal investigation material.⁸ However, the version of the bill publicly introduced by Senator Specter omits a provision, circulated in earlier discussion drafts and embodied within proposed Federal Rule of Evidence 502(c), which would have treated voluntary disclosures to the government as not constituting a general waiver of the privilege. Under the current state of the law in most jurisdictions, such disclosures are viewed as general waivers.⁹

Commentary on the McNulty Memorandum

Reaction to the McNulty Memorandum has been mixed. Some commentators believe it represents a fundamental shift in the Justice Department's practices, ending a general perception that privilege waivers had become "virtually mandatory" for a corporation seeking to cooperate with a DOJ investigation.¹⁰ Others have adopted a wait and see approach to how the McNulty Memorandum plays out in practice,¹¹ while embracing the Memorandum's elimination of the reimbursement of legal fees as a factor of consideration in assessing a corporation's cooperation.¹²

Much commentary on the Memorandum has been negative – arguing that the Memorandum did not go far enough, still permits prosecutors to demand waivers of the privilege, that the Memorandum institutionalizes the "culture of waiver," and that prosecutors determined to have corporations waive the privilege will continue to demand waivers.¹³ In addition to these broader concerns, the McNulty Memorandum has been criticized for placing corporations under investigation in a "Catch-22" situation, where even if a corporation does not receive a request to waive the privilege, it is still told that it may be given cooperation credit for waiving the privilege.¹⁴ In a similar vein, the Memorandum has been described as effectively a "don't ask, don't tell policy," that

"[t]he government raises the prospect of getting information but doesn't ask for it. You still have every bit as much pressure to waive."¹⁵

Notably, and consistent with other Department of Justice internal guidelines, the McNulty Memorandum confers no rights upon witnesses, subjects or targets of investigation, let alone criminal defendants. As a result, if a prosecutor chooses to ignore the Memorandum's procedural requirements, "there is nothing that the accused can do in response. As long as the possibility exists that DOJ will allow someone to ask for a waiver of the attorney-client privilege, the privilege is in jeopardy."¹⁶ Additional criticisms have included the fact that the McNulty Memorandum fails to address a number of additional provocative factors found in the Thompson Memorandum that prosecutors are required to take into account. These include whether a corporation enters into joint defense agreements, whether the corporation shares information with its employees under investigation, and whether a corporation disciplines or fires employees who refuse to cooperate in an investigation.¹⁷

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Discussion

The McNulty Memorandum goes beyond the step taken by the Department of Justice in October of 2005, when it issued what was referred to as the McCallum Memorandum, requiring each United States Attorney's Office to promulgate a set of protocols to be followed before a privilege waiver request could be made to a corporation.¹⁸ But the now-superseded McCallum Memorandum was all process and no substance. It did not address the more controversial aspects of the Thompson Memorandum, nor did it quiet the Thompson Memorandum's critics.

If the bulk of the initial commentary is credited, the McNulty Memorandum may share the same fate. While the McNulty Memorandum represents a bigger step, it does not go nearly far enough. Government prosecutors retain the option to seek waivers of the attorney-client privilege—the oldest privilege in the law—and determined prosecutors are likely to continue to seek them in complex white collar cases, especially where corporations have retained outside counsel to investigate.

Moreover, the distinction the McNulty Memorandum purports to recognize, between Category I “purely factual information” and Category II “attorney-client communications or non-factual attorney work product,” may not be especially meaningful in practice. For instance, memoranda of interview or “hot documents” prepared or chosen by a company's investigating counsel necessarily reflects counsel's work product based on the questions asked, answers recorded, and documents selected. Yet the McNulty Memorandum presumably expects “cooperating” corporations to produce such material to the Government and, by operation of the laws of most jurisdictions, to the rest of the world. Given that expectation, investigating counsel can expect to continue to see less rather than more candor from employees who cannot be assured of confidentiality through the operation of the attorney client privilege and work product doctrine.

On the other hand, the McNulty Memorandum is likely to curtail routine privilege waiver demands from line prosecutors, at least when they are on the fence as to whether to ask for them. Obtaining Deputy Attorney General and other Main Justice approval is often a time-consuming process,

requiring the creation of a lengthy memorandum by line prosecutors followed by significant internal review within the Department. This hurdle is likely to dissuade some, but not all.

Soon, we may all be able to judge, objectively, the McNulty Memorandum's impact. Given the Memorandum's substantial record making and record keeping requirements, the Justice Department will be able to gather, analyze and disseminate statistical data showing the number of requests for waivers made, granted and rejected—broken down by office and prosecutor if need be. Such data, if the Department makes it available, may go a long way to proving, one way or another, whether the culture of waiver persists and whether stronger measures, such as Senator Specter's bill, continue to be justified.

Notes

1. Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. An earlier version of the memorandum issued by then-Deputy Attorney General Eric Holder in 1999 advised prosecutors that they could—but were not required to—take those factors into account. See *Independence of the Legal Profession: Federal Government Policies on Privilege Waiver*, available at <http://www.abanet.org/poladv/priorities/privilegewaiver.html>.
2. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 34-44969 (Oct. 23, 2001), available at <http://www.sec.gov/litigation/investreport/34-44969.htm>.
3. See Letter from Robert D. Evans, Director of the American Bar Association's Governmental Affairs Office to the United States Sentencing Commission (March 28, 2006), available at <http://www.abanet.org/poladv/labausc32806.pdf>; Speech by SEC Commissioner: Remarks Before the Federalist Society (Sept. 21, 2006), available at <http://sec.gov/news/speech/2006/spch092106psa.htm> (“I strongly believe that the Commission should not view a company's waiver of privilege as a factor that will afford cooperation credit... Maybe it is time for the Commission to revisit this issue in a formal way and to clarify that waiver of fundamental rights and protections will not result in lesser allegations and/or remedies”); McLucas, Shapiro & Song, *The Decline of the Attorney-Client Privilege in the Corporate Setting*, 96 J. Crim. L. & Criminology 621 (2006). On February 5, 2007, the President of the American Bar Association wrote to the Chairman of the SEC, urging the SEC to revise its cooperation guidelines to bar the SEC staff from demanding that companies waive the privilege.

4. *United States v. Stein*, 435 F. Supp. 2d 330 (SDNY 2006); 440 F. Supp. 2d 315 (SDNY 2006).

5. Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006), available at http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.

6. The prior approval requirement resembles the existing obligation imposed on federal prosecutors to obtain prior approval from the Assistant Attorney General for the Criminal Division before a grand jury subpoena may be issued to an attorney relating to the attorney's representation of a client. United States Attorneys Manual § 9-13.410.

7. Senator Specter did not formally introduce the legislation. Instead, he brought the legislation to the Senate floor, made remarks about it and put the text of the legislation in the Congressional Record. On January 4, 2007, Senator Specter formally introduced the bill in the new Congress, as the Attorney-Client Privilege Protection Act of 2007, S. 186, available at <http://www.govtrack.us/data/us/bills/text/110/s/s186.pdf>.

8. According to the December 7, 2006 press release issued by the Senate Judiciary Committee, "The bill seeks to protect the attorney-client relationship by: Prohibiting federal lawyers and investigators from: requesting that an organization waive its attorney-client privilege or work product doctrine; and conditioning any charging decision or cooperation credit on waiver or non-waiver of privilege, the payment of an employee's legal fees, the continued employment of a person under investigation, or the signing of a joint defense agreement. Preserving the organizations ability to offer internal investigation materials to federal prosecutors, but only if such an offer is voluntary and unsolicited by the prosecutors. Allowing prosecutors to seek materials that they reasonably believe are not privileged."

9. A minority of jurisdictions have held that selective disclosure of privileged materials to the government does not constitute a global waiver. See *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978) (en banc) (holding that only a limited waiver of the privilege occurred when party disclosed documents in SEC investigation); *In re LTV Sec. Litig.*, 89 FRD 595, 605 (ND Tex. 1981) ("[D]isclosure of the additional materials to the SEC does not justify the class' discovery of the identity of those documents"); *In re Grand Jury Subpoena Dated July 13, 1979*, 478 F. Supp. 368, 373 (D. Wis. 1979) (holding that release of report to SEC and IRS is not waiver of the attorney-client privilege).

10. See Wachtell, Lipton, Rosen & Katz Client Newsletter, *DOJ Adopts Revised Policies on Corporate Prosecutions*, available at <http://online.wsj.com/public/resources/documents/wachtell121306.pdf> ("In the past, because of the Thompson Memo's now-superseded language, such corporations had assumed that waiver of the attorney-client privilege was virtually mandatory; not surprisingly, corporate waivers had become increasingly common in recent years. That assumption no longer applies."); see also Pillsbury Winthrop Shaw Pittman LLP Client

Newsletter, *The McNulty Memorandum: DOJ Reverses Course on Privilege Waivers and Reimbursement of Attorneys' Fees*, available at <http://www.pillsburylaw.com/content/portallpublications/2006/12/2006122116124421/Corp%20Inv%20Vo%201605%20No%206056%2012-21-06.pdf>.

11. See *Justice Softens Investigation Guidelines*, BUSINESS WEEK, Dec. 13, 2006, available at http://www.businessweek.com/bwdaily/dnflash/content/dec2006/db20061213_615165.htm?chan=search (quoting the Senior Counsel to the President of the U.S. Chamber of Commerce: "One of our options might be to look at [the McNulty Memorandum] for six months").

12. See, e.g., U.S. Chamber of Commerce Press Release, *New DOJ Policy Does Not Adequately Protect Attorney-Client Privilege*, available at <http://www.uschamber.com/press/releases/2006/december/06-190.htm> (quoting the Senior Counsel to the President of the US Chamber of Commerce: "We support DOJ's position that eliminates payment or reimbursement of legal fees as a factor of consideration"); Association of Corporate Counsel Press Release, *US Deputy Attorney General Paul J. McNulty Revises Charging Guidelines for Prosecuting Corporations*, available at <http://www.acc.com/php/cms/index.php?id=84&fid=1086> "[Association of Corporate Counsel] applauds one aspect of the [McNulty Memorandum] that removes one Thompson Memo cooperation criteria. The McNulty Memo will no longer include language saying that payment of employee's legal fees can be used as a negative factor in determining a company's level of cooperation".

13. See, e.g., *Thompson Memo Changes Not Enough, ABA Says*, 49 ABAJEREP 1, 5 (Dec. 15, 2006); *McNulty Memo on Attorney-Client Privilege Blasted for Lack of Change*, THE NATIONAL LAW JOURNAL, Jan. 26, 2007, available at <http://www.law.com/jsp/ihel/PubArticleFriendlyIHC.jsp?id=1169719351771> (quoting ABA task force advisor Stephen K. Hazen: "Comparing the McNulty memo line by line with the Thompson memo, there is almost no change... [And the Justice Department] institutionalize[s] artificially the entire attorney work-product protection area as trivial"); *The 'McNulty Memo': Real Change, or Retreat?*, THE NATIONAL LAW JOURNAL, Dec. 20, 2006, available at <http://www.nacdl.org/public.nsf/PrinterFriendly/WCNews066?openDocument>; Janis, *The McNulty Memorandum: Much Ado About Nothing*, WASHINGTON LAWYER at 35 (Feb. 2007); Winston & Strawn LLP Client Newsletter, *The McNulty Memorandum: The Department of Justice Releases New Policies and Procedures Regarding Waiver of Attorney-Client Privilege and Attorney Work Product Protections and Corporate Advancement of Attorney Fees*, available at <http://www.winston.com/siteFiles/publications/McNultyMemorandum.pdf>.

14. See *Thompson Memo Changes Not Enough, ABA Says*, supra note 13; Kaye Scholer Client Newsletter, *Justice Department Issues McNulty Memorandum*, available at [http://www.kayescholer.com/web.nsf/040A0868ABD4CA76385257257005F8-BEF/\\$file/WhiteCollarUpdateJan2007.pdf?openelement](http://www.kayescholer.com/web.nsf/040A0868ABD4CA76385257257005F8-BEF/$file/WhiteCollarUpdateJan2007.pdf?openelement) (noting that under the McNulty Memorandum, DOJ possesses the ability to penalize companies that fail to produce Category I information,

and reward companies that voluntarily produce Category II information).

15. *McNulty Memo on Attorney-Client Privilege Blasted for Lack of Change*, *supra* note 13, quoting Steven K. Hazen.

16. Podger, *The McNulty Memo- Attorney-Client Privilege Waivers & Attorney Fees*, Dec. 12, 2006, available at http://lawprofessors.typepad.com/whitecollarcrime_blog/2006/12/the_mcnulty_mem.html.

17. Association of Corporate Counsel Press Release, *supra* note 12.

18. See Memorandum from Robert D. McCallum, Jr., Acting Deputy Attorney General to Heads of Department Components and United States Attorneys (Oct. 21, 2005), available at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00163.htm.

SHAREHOLDER ACCESS

“Access” By Default: SEC’s “No View” on Shareholder Access Proposal Opens the Door

By Keir D. Gumbs and John W. Madison

On January 22, 2007, the Securities and Exchange Commission’s Division of Corporation Finance issued a long-awaited response to a no-action request from Hewlett-Packard Company to exclude from its proxy materials a shareholder proposal from the American Federation of State, County and Municipal Employees Pension Plan and several other pension plans. The proposal is a mandatory bylaw amendment that, if approved, would amend Hewlett-Packard’s bylaws to permit a shareholder or group of shareholders owning three percent or more of Hewlett-Packard’s common stock to make nominations to Hewlett-Packard’s board of directors and to have such shareholder or group of shareholders’ nominees included in the proxy materials for Hewlett-Packard’s annual meeting of shareholders.

In most years, the staff’s response to Hewlett-Packard would be a non-event; the staff historically has granted such requests on the basis that such proposals may be excluded in reliance on the “election of directors” exclusion under Rule 14a-8(i)(8). This year, however, the staff’s response was significant for two reasons. First, it is the first time the staff has considered this kind of proposal since the US Court of Appeals for the Second Circuit rejected the staff’s historical approach to such proposals under Rule 14a-8(i)(8) in *American Federation of State, County and Municipal Employees, Employees Pension Plan v. American International Group, Inc.*¹ Second, instead of granting or denying relief, the staff punted—it expressed no view on the merits of Hewlett-Packard’s arguments for exclusion.

Historical Approach to Election Proposals

Under Rule 14a-8(i)(8), the so-called “election of directors” exclusion, a company may exclude from

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its proxy materials any shareholder proposal that “relates to an election for membership on the company’s board of directors or analogous governing body.” The SEC adopted this exclusion to prevent shareholders from taking advantage of the shareholder proposal process created under Rule 14a-8 by submitting proposals that oppose or solicit support for nominations to the board of directors. Based on these principles, the staff’s analysis under the “election of directors” exclusion has focused on whether the proposal and supporting statement, taken as a whole, attempt to make nominations to the board of directors, question the judgment of company nominees to the board of directors or seek the removal of current members of the board.

The elections exclusion and the staff’s interpretations thereunder long have drawn the ire of shareholders who seek to require that companies include their nominees to the board of directors in companies’ proxy materials. This is because the staff’s interpretation of Rule 14a-8(i)(8) has relegated shareholders seeking to nominate directors to the process available under Rule 14a-12, related proxy rules and state law. Under those processes, shareholders may request that a company include their nominees in the company’s proxy materials, solicit proxies for their candidates themselves, or nominate their candidates from the floor of an annual meeting. None of these options have proven to be very useful. Companies often decline to include shareholder nominees in their proxy materials, while the costs of conducting a proxy solicitation are usually prohibitively high. Making nominations on the floor of an annual meeting is not a recipe for success either; so few shareholders attend annual meetings of shareholders that nominations made on the floor of a meeting almost never garner enough support to be successful.

Shareholder Access

In 2003, following previous unsuccessful rule-making efforts, the Commission attempted to address these issues by proposing Rule 14a-11, the

so-called “shareholder access” rule. Under proposed Rule 14a-11, a company would be required to include the nominees of shareholders owning more than five percent of the company’s stock in its proxy materials if one of two triggering events occur: first, if the company’s shareholders approved a Rule 14a-8 shareholder proposal to subject the company to Rule 14a-11; or second, if one of the company’s nominees for the board received “withhold” votes from more than 35 percent of the votes cast. Once triggered, Rule 14a-11 would have permitted an eligible shareholder to nominate up to three candidates to the board, depending on the size of the company’s board. However, it would not have permitted a shareholder to nominate a majority of the board of directors.

The proposed rule proved too controversial. Debates over the appropriateness of the shareholder opt-in trigger, the proper thresholds for the withhold trigger and the minimum ownership requirements of the rule kept the Commissioners from reaching consensus. Subsequently, two of the rule’s three champions, former Chairman William Donaldson and Commissioner Harvey Goldschmid, left the Commission and many observers speculated that shareholder access was dead. They would have been right—at least until AFSCME submitted a shareholder proposal modeled after proposed Rule 14a-11 to American International Group (AIG) in 2004.

AFSCME v. AIG

In the 2004 proxy season, AFSCME submitted a shareholder proposal to AIG that was modeled after the SEC’s proposed shareholder access rule. If approved, the proposal would have amended AIG’s bylaws to require that shareholder-nominated candidates for the board of directors be included in AIG’s annual meeting proxy materials. AIG requested and obtained no-action relief from the staff in connection with its plans to exclude the proposal from its proxy materials in reliance on Rule 14a-8(i)(8).

Undaunted by the staff’s response, AFSCME brought suit in the US District Court for the Southern District of New York. It sought declaratory and injunctive relief preventing AIG from excluding the proposal from the proxy materials for AIG’s next annual meeting of shareholders. The district court sided with AIG, ruling that, based on the SEC’s historical interpretation of

Rule 14a-8(i)(8), the proposal related to an election and could therefore be excluded under Rule 14a-8(i)(8). On appeal, however, the US Court of Appeals for the Second Circuit disagreed with the district court. It found the Commission’s interpretation and statements regarding Rule 14a-8(i)(8) to be internally inconsistent, particularly with regard to the distinction between proposals that relate to a particular election and a proposal like the AFSCME proposal, which “establishes a process for shareholders to wage a future election contest.” The former clearly would be excludable under Rule 14a-8—but the latter, according to the court, would not.

In dicta, the Second Circuit seemed to invite the Commission to revise and clarify its interpretation of Rule 14a-8(i)(8), under the conditions that the Commission explain its reasons for doing so and that the Commission do so through the proper administrative law channels, such as by Commission, rather than staff action. In reversing the lower court’s decision and remanding the case for further review, the Second Circuit stated, “Although the SEC has substantial discretion to adopt new interpretations of its own regulations in light of, for example, changes in the capital markets or even simply because of a shift in the Commission’s regulatory approach, it nevertheless has a ‘duty to explain its departure from prior norms.’”

In response to the challenge from the Second Circuit, the Commission issued a press release stating its intention to amend Rule 14a-8 as a result of the Second Circuit’s decision in the AIG case. To date, no such action has taken place and it is not clear when such action will be scheduled. Since issuing the press release, the Commission has delayed its consideration of a response to the court’s decision in the AIG case on multiple occasions. In the meantime, through speeches and other public statements, the members of the Commission have expressed their general support or opposition to shareholder access.

Hewlett-Packard No-Action Request and Response

While the Commission debated how to respond to the Second Circuit decision in the AIG case, Hewlett-Packard submitted a no-action request in connection with its plans to exclude a new shareholder access proposal from AFSCME that was modeled

after the proposal that was the subject of the AIG case. Hewlett-Packard argued that, based on the staff's historical interpretation of Rule 14a-8(i)(8) and that, as a California-based company, it was not subject to the Second Circuit's decision in the AIG case, it could exclude the AFSCME proposal from its proxy materials, notwithstanding the decision of the Second Circuit in the AIG case. On January 22, 2007, the staff responded to Hewlett-Packard's no-action request. In its response, the staff acknowledged the Second Circuit's decision in the AIG case but declined to grant or deny no-action relief. Instead, the staff expressed "no view" on the substantive merits of the proposal and based its decision on a lack of clarity on the jurisdictional application of the AIG case, noting "Your letter assumes that the Ninth Circuit is the applicable jurisdiction for purposes of this request. Since we are unable to dispute or concur in this assumption, we express no view concerning whether HP may exclude the proposal under rule 14a-8(i)(8) as relating to an election for membership on its board of directors."

As a general matter, the staff's decision to express "no view" with regard to a no-action request forces a company to choose between two equally undesirable alternatives: It can (a) exclude the proposal from its proxy materials and risk SEC enforcement action or shareholder lawsuit or (b) include the proposal in its proxy materials and risk its approval by shareholders. Of these choices, the second choice likely is less risky. To choose to exclude a shareholder proposal in the absence of a no-action letter from the staff would be to risk an SEC enforcement action under the proxy rules. While we are not aware of an instance in which the SEC has brought an enforcement action under such circumstances, the very practice of issuing no-action letters itself is premised on the threat—real or not—of an SEC enforcement action for improperly excluding a shareholder proposal under Rule 14a-8.

Based on recent years' experience, however, the greater threat to a company that excludes a shareholder proposal in the absence of a no-action letter is the threat of a shareholder lawsuit. The Second Circuit's decision in the AIG case marks the latest in a series of cases brought by shareholder groups seeking redress in the federal courts against public companies that have excluded shareholder proposals from their proxy materials. Emboldened by public opinion, shareholders increasingly have chosen to litigate

rather than negotiate to get their proposals included in companies' proxy materials. If a shareholder is successful in court, the company may be enjoined from holding its annual meeting of shareholders until it has distributed additional or revised proxy materials that include the shareholder proposal and an additional proxy card, drawing more attention to the shareholder proposal than the company likely desires. Faced with these considerations and risks, a company that receives a "no view" response from the staff may decide to forgo the battle and simply include the proposal in its proxy materials. In the end, this was the course chosen by Hewlett-Packard.

Shareholder Access by Default

So far, there have been only two companies (other than Hewlett-Packard) reported to have received shareholder access proposals under Rule 14a-8. In some ways, this is a victory for those opposed to shareholder access; the deadline for submitting shareholder proposals for annual meetings in the spring of this year already has passed, and thus most companies will not have to deal with shareholder access proposals this season. This, of course, is of little consolation for the two other companies that have received such a proposal this season and companies with annual meetings that are held later this year.

It is unlikely that the Commission will propose and adopt amendments to Rule 14a-8 in time to be of assistance to the companies that already have received shareholder access proposals or that may receive such proposals in connection with annual meetings held later this year. Before it can adopt amendments to Rule 14a-8 that respond to the Second Circuit's decision, the Commission will have to propose such amendments, publish them for public comment, adopt the amendments, and allow some period of time (typically 30 to 60 days) before the amendments become effective. If the prior attempts at addressing shareholder access are at all demonstrative of what can be expected of the next attempt at such rulemaking, it will be months before the Commission will be in a position to take action. Theoretically, the Commission could adopt an interpretive release that responds to the Second Circuit's decision during that span, but given the level of discord among the Commissioners about how the Commission should approach shareholder access, this seems questionable.

The Commission's failure to respond to the Second Circuit's decision has opened the door for new shareholder access proposals, including proposals that may vary significantly from the SEC's original shareholder access proposal. For example, unlike the shareholder access rule proposals, which required that a nominating shareholder own at least five percent of a company's securities, a shareholder access proposal may impose minimal share ownership requirements (or no share ownership requirements at all), subject only to the provisions of a company's governing instruments and applicable state law. Similarly, unlike the shareholder access rule proposals, a shareholder access proposal could allow shareholders to nominate a full slate of directors, as opposed to the short slate proposed by the Commission, and still evade exclusion to the extent that the staff

maintains a "no view" approach to shareholder access proposals.

Although opponents of shareholder access may continue to find new arguments to exclude shareholder access proposals, the staff's response to Hewlett-Packard precludes reliance on the "election of directors" exclusion. As a result, until the Commission takes action to address the Second Circuit's decision, it may find that the staff's response will have consequences that were not anticipated at the time that the letter was issued. For now at least, the Hewlett-Packard no-action letter may have created shareholder access by default.

Notes

1. 462 F.3d 121 (2d Cir. 2006).

SHAREHOLDER ACTIVISM

Seven Things Shareholders Want Directors to Understand in 2007

By Ira M. Millstein, Holly J. Gregory, and Rebecca C. Grapsas

As tensions between boards and shareholders continue to run high, boards may find it beneficial to consider anew the fundamental roles of owners, boards and managers, and the practices that such roles suggest. Such an effort was undertaken more than fifteen years ago, when a working group representing large public companies and institutional investors developed a set of principles that aimed to reconcile the tensions between owners and boards as they existed at the time (*A New Compact for Owners and Directors*, HARVARD BUSINESS REVIEW, July-August 1991, at 41-see further). Many of these principles later became best practices and some have even been enshrined in listing rules, including executive sessions and independent compensation and nominating committees. In recent years, tensions around just what best practices are “critical” have risen—with companies feeling increasingly pressured to “tick boxes” to comply with the rigid, one-size-fits-all views emanating from proxy advisory firms. We encourage boards to resist the box-ticking approach while finding pragmatic solutions that work for their own particular circumstances—but grounded in an understanding of shareholders’ legitimate expectations and concerns. What follows are our observations on these expectations and concerns.

- **Shareholders seek a meaningful say in who sits on the board.** Board accountability to shareholders is really what majority voting is all about. The calls for majority voting are significant and momentum for change is accelerating. Boards that resist this change risk more contentious relations with shareholders. Shareholders will continue to seek some means of more formally nominating directors through the proxy process. Directors should give thought to possible solutions which do not disrupt the election process.

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- **Shareholders lack trust in a board that lacks independent leadership.** Shareholders expect that the independent directors have a board leader who is either a non-executive chair or a lead director with a defined set of responsibilities reflecting an appropriate balance of power between the CEO and the independent directors. Without such a leader, shareholders view the ability of the board to exercise oversight to be structurally compromised, particularly with respect to issues where management may have natural blind spots, such as monitoring CEO performance and evaluating the strategic plan.
- **Shareholders expect disclosure to reveal the company’s true condition.** Beyond GAAP and the line item disclosure rules, what shareholders really want is to understand material developments that impact the company’s true condition. That’s why sensitivity to how close to the “line” a judgment call on disclosure is, really matters.
- **Shareholders are skeptical of complex compensation schemes.** Shareholders are tired of high bonuses during periods of non-performance, options spring-loading and backdating, extravagant perks and excessive severance payments and pensions. Compensation should be principled, simple and understandable—and not overly generous. Shareholders expect to pay a decent wage relative to responsibilities, including incentives for performance, and reasonable benefits. They are suspicious of perks and want them to be justified. Remember that compensation structures reveal much about the type of leadership and ethics at a company, whether rewarding an imperial CEO, encouraging strong team leadership or something in between. Shareholders are considering the advisory vote on executive compensation by shareholders in the UK as a potential means of obtaining some dialogue on excesses.
- **Shareholders want exit scenarios to be reasonable.** If a CEO has engaged in inappropriate

Extracts from “A New Compact for Owners and Directors”

(Harvard Business Review, July-August 1991, at 41)

Directors:

1. The board of directors should evaluate the performance of the chief executive officer regularly against established goals and strategies.
2. This evaluation should be performed by “outside” directors.
3. All outside directors should meet alone, at least once a year, coordinated by a leader.
4. Directors should establish appropriate qualifications for board members and communicate those qualifications clearly to shareholders.
5. Outside directors should screen and recommend candidates based on qualifications established by the board.

Shareholders:

1. Institutional shareholders of public companies should see themselves as owners, not just investors.
2. Shareholders should not be involved in the conduct of the company’s day-to-day operations
3. Shareholders should evaluate the performance of the directors regularly.
4. In evaluating the performance of directors, shareholders should be informed.
5. Shareholders should recognize and respect that the only goal common to all shareholders is the ongoing prosperity of the company.

Members of the Working Group on Corporate Governance:

1. *Martin A. Coyle*: executive vice president, general counsel and secretary, TRW Inc.,

Cleveland, Ohio; former chairman, American Society of Corporate Secretaries; member, Lawyers Steering Committee of The Business Roundtable Corporate Governance Task Force.

2. *Richard H. Koppes*: general counsel, California Public Employees’ Retirement System, Sacramento, California; past president, current secretary-treasurer, and executive board member of the National Association of Public Pension Attorneys.

3. *David B.H. Martin*: partner, Hogan & Hartson, Washington, DC; former special counsel to the chairman, Securities and Exchange Commission.

4. *Ira M. Millstein*: senior partner, Weil, Gotshal & Manges LLP, New York, New York; chairman of the board of advisors, Institutional Investor Project, Columbia University School of Law, Center for Law & Economic Studies; chairman, Governor Cuomo’s Task Force on Pension Fund Investment.

5. *Philip R. O’Connell*: lawyer and consultant; former senior vice president and secretary of Champion International Corporation, Stamford, Connecticut; former chairman, American Society of Corporate Secretaries; member, Corporate Governance Subcommittee, New York Stock Exchange Legal Advisory Committee; member and former chairman, Lawyers Steering Committee of The Business Roundtable Corporate Governance Task Force.

6. *Sarah A.B. Teslik*: executive director, Council of Institutional Investors, Washington, DC

7. *Clifford L. Whitehill*: senior vice president, general counsel and secretary, General Mills, Inc., Minneapolis, Minnesota; chairman, Lawyers Steering Committee of The Business Roundtable Corporate Governance Task Force.

8. *Nancy A. Williams*: deputy executive director and general counsel, Public Employees’ Retirement Association of Colorado, Denver, Colorado; past member, executive committee, National Conference on Public Employees’ Retirement Systems; past president and current executive board member, National Association of Public Pension Attorneys.

behavior—or just isn’t performing well—shareholders do not want that CEO to be paid a fortune to leave. Consider reasonable exit scenarios and

reasonable pension packages during the CEO’s tenure when contracting with the CEO in the first place. Beware deferred compensation

practices—what looks reasonable now may appear overly rich in hindsight when described as a lump sum. Perception matters.

- ***Shareholders expect the board to take responsibility—and change the board—when necessary.*** When a company is mired in scandal involving significant unacceptable behavior by the CEO or members of his or her senior leadership team over time, whether or not the board was culpable, shareholders expect the board to accept responsibility, and change its behavior and/or composition—because it happened on its watch.
- ***Shareholders should be able to effect change.*** When shareholders lose faith in the ability of management and the board to perform, they should not have to face insurmountable barriers to effecting change. Perform and all is well. Underperform for a significant period and control should be contestable—which brings us back to board selection and accountability.

Shareholders want boards to think creatively about how to address their legitimate concerns. They want boards to recognize that, as James E. Burke, the former CEO of Johnson & Johnson says, “being a business leader is about giving—not taking.” That means shareholders need business leaders who can act in an economically rational way on behalf of shareholders, employees and other constituents, and who embody Adam Smith’s moral values of prudence, justice and integrity. Shareholders need to be able to trust the boards to which they have delegated key oversight functions. Likewise, boards have the right to expect that shareholders will act as owners—as their compatriots recognized fifteen years ago—and refrain from adopting rigid, box-ticking methods of judging good governance. They want shareholders to focus on the fundamentals that are common to all.

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BOARD OF DIRECTORS

Delaware Supreme Court Reaffirms the *Caremark* Standard and Clarifies Duty of Good Faith in the Wake of *Disney*

By Dale E. Barnes and Beth I.Z. Boland

On November 6, 2006, the Delaware Supreme Court reaffirmed the deferential standard for director oversight liability set forth by the Court of Chancery a decade ago in *In re Caremark International Derivative Litigation*. The court held that imposition of liability requires a clear showing that the directors either *knew* they were not discharging their fiduciary obligations or showed a conscious disregard for their responsibilities. Perhaps more importantly, the Supreme Court also took the opportunity to clarify the role of the “duty of good faith” most recently articulated in its decision in *In re Walt Disney Co. Derivative Litigation* decision. In so doing, it made clear that the duty of good faith does *not* stand as a separate duty, but rather is encompassed under the traditional rubric of the duty of loyalty. As a result, corporate officers and directors who fail the “good faith” standard may not be eligible for corporate exculpation, indemnification or, potentially, insurance coverage for their actions. And, by shifting the standard in the context of a “failure of oversight” case—as opposed to one involving affirmative director decisionmaking—the decision may result in a dramatic increase in director risk.

Background and Key Holdings

In 2004, AmSouth and its wholly-owned subsidiary, AmSouth Bank, paid \$40 million in fines and \$10 million in civil penalties to resolve government and regulatory investigations related to the failure of bank employees to file “Suspicious Activity Reports” (SARs), as required by the federal Bank Secrecy Act and various anti-money-laundering regulations. No fines or penalties were imposed on AmSouth’s directors, and no other regulatory action was taken against them.

Plaintiffs William and Sandra Stone, AmSouth shareholders, filed a derivative action against fifteen

present and former directors of AmSouth, alleging the directors were liable for the \$50 million in fines and penalties levied by federal regulators. They did not make a pre-suit demand, but instead asserted demand was futile. The Court of Chancery dismissed the complaint for failure to adequately plead that such a demand would have been futile. Plaintiffs appealed.

1. Pleading Requirements to Show Demand Futility

For the plaintiffs to show that demand was futile and therefore their failure to make such a demand was excused, they would have to show through the particularized factual allegations in the complaint that there was a “reasonable doubt” at the time the complaint was filed that “the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” The plaintiffs attempted to show the directors could not be disinterested or independent by asserting that the defendant directors “face[d] a substantial likelihood of liability.” However, according to the section 102(b)(7) provisions of AmSouth’s certificate of incorporation, directors faced the potential for monetary liability only if they engaged in conduct that was not in good faith or breached the duty of loyalty. Breaching the duty of care, alone, would not lead to monetary liability. Therefore, the plaintiffs had to assert facts sufficient to show that the AmSouth directors’ conduct rose above the level of gross negligence and either was not in good faith or breached the duty of loyalty.

2. Board Oversight

The plaintiffs acknowledged the AmSouth directors neither knew nor should have known that violations of the law were occurring. However, the plaintiffs argued that demand was futile because the directors had “utterly failed to implement any sort of statutorily required monitoring, reporting or

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information controls that would have enabled them to learn of problems requiring their attention.” The defendants argued that these assertions were contradicted by the derivative complaint itself and by several documents incorporated therein by reference.

The complaint referred to an independent report prepared by KPMG that reviewed AmSouth’s compliance efforts. According to the court, this report reflected that AmSouth’s Board dedicated considerable resources to various compliance programs and “put into place numerous procedures and systems to attempt to ensure compliance.” These included: (1) a compliance officer who was responsible for employee training, keeping up to date on compliance issues, and reporting to the Board; (2) a compliance department led by the compliance officer and employing nineteen other professionals; (3) a corporate security department responsible for the detection and reporting of suspicious activity; and (4) a “Suspicious Activity Oversight Committee” that actively oversaw the compliance programs and deterred, detected, and reported “money laundering, suspicious activity and other fraudulent activity.”

However, the court also noted that the Department of the Treasury’s Federal Crimes Enforcement Network (FinCEN) found in its investigations of AmSouth that “AmSouth’s [compliance] program lacked adequate board and management oversight,” and that “reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient.” AmSouth neither admitted nor denied FinCEN’s determinations.

3. Delaware Supreme Court Decision

The Supreme Court upheld the Court of Chancery decision dismissing the complaint for failure to properly allege demand futility. The court held the plaintiffs failed to create a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in responding to a demand, because the plaintiffs did not plead the existence of any “red flags” that would have warned the board of problems. In addition, the KPMG report, which listed several steps the board took to ensure regulatory compliance *before* the investigations began, belied plaintiffs’ claims that the board never took those steps. Because the plaintiffs had not

shown the directors either knew or should have known that violations of the law were occurring, nor had they shown the directors “utterly failed to implement any reporting or information system or controls,” they could not show that the directors’ conduct rose to the level of bad faith or a breach of the duty of loyalty, and therefore, could not excuse their failure to make a pre-suit demand on the board.

In so doing, the court also reaffirmed and elaborated on the *Caremark* legal standard for director oversight liability, and clarified the parameters of the “duty of good faith” recently addressed in *Disney*.

a. *Caremark*, *Disney*, *Stone* and the Evolving Good Faith Standard For Director Oversight Liability

As followers of Delaware compliance decisions know, the *Caremark* court held that where a plaintiff claims director liability for corporate loss predicated upon the director’s ignorance of the liability-creating activities within the corporation, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”

The Delaware Supreme Court later elaborated on this standard in *In re Walt Disney Co. Derivative Litigation*, holding that “a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence).” The *Disney* court articulated three examples of conduct that would establish a failure to act in good faith: (1) “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation,” (2) “where the fiduciary acts with the intent to violate applicable positive law,” or (3) “where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” This final example describes, and is consistent with, the lack of good faith conduct that the *Caremark* court held was a necessary condition for director oversight liability.

Finally, in *Stone*, the court stated it would not find liability without a clear showing that the directors knew they were not discharging their fiduciary obligations. Thus the two necessary conditions predicate

for director oversight liability are: “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, [they] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”

b. Good Faith and the Duties of Loyalty and Care

In reaffirming *Caremark*, importantly the court also took the opportunity to clarify the legal framework under which issues of good faith should be considered in the wake of *Disney*. In *Disney*, the Supreme Court left open the issue of whether the “duty of good faith” could be considered a *third* “duty,” separate from and equal to the duties of care and loyalty. The *Stone* court quickly put that question to rest. The court clarified that, although failure to act in good faith “requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence),” good faith “is a *subsidiary* element, *i.e.*, a condition, of the fundamental duty of loyalty” (emphasis added). Indeed, the court stated that “a failure to act in good faith is not conduct that results, *ipso facto* in the direct imposition of fiduciary liability.” Thus, only breach of the duties of care or loyalty may result in direct liability; failure to act in good faith may also result in liability, but only indirectly, through a breach of the duty of loyalty. As a consequence of this new interpretation, liability for breach of “the duty of loyalty now is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.”

This conclusion appears to represent a dramatic expansion of the concept of the duty of loyalty. Before *Stone*, it was far from a foregone conclusion that the duty of good faith was an aspect of the duty of loyalty, as opposed to a free-standing fiduciary duty or a version of the duty of due care. Many cases in which an officer or director has been charged with breaching the duty of good faith involved precisely the type of conduct that is typically considered a breach of the duty of care, *i.e.*, one in which the contested conduct did not result from personally-conflicted loyalties. Indeed, the conduct at issue in *Stone*—which amounts to lack of director oversight of employee misconduct—is similar to that in *Caremark*, where the

courts characterized the alleged misconduct as constituting a breach of the duty of care.

In *In re Caremark Intern. Inc. Deriv. Litig.*¹, the court expressly examined a failure to monitor claim under the rubric of the duty of care. The court noted that, in assessing liability for breach of the duty of care resulting from lack of oversight, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exist—will establish the lack of good faith that is a necessary condition to liability.”² The duty of loyalty, in stark contrast, has typically covered director action that involves some type of financial self-interest connected to a transaction.³ Conduct that has been found violative of the duty of loyalty includes usurping a corporate opportunity.⁴

Now, without any discussion of the significance of its decision, the Delaware Supreme Court in *Stone* has transformed the *Caremark* standard from a duty of care issue into a duty of loyalty issue. In so doing, the *Stone* decision threatens to swallow the duty of due care: if an officer or director’s lack of due care rises to the level of “utterly failing” to implement or oversee a company’s systems or controls, he/she may have failed to act in good faith, and thus breach the duty of loyalty. This qualitative shift not only has broad theoretical implications, but also poses very dramatic—and troubling—practical implications for officers and directors. Unlike a duty of care violation, where a director enjoys the protection of the exculpatory clause under § 102(b)(7) and is entitled to indemnification by the company, a finding that a director breached his duty of loyalty extinguishes those benefits. As the *Stone* court made clear, the duty of loyalty no longer is limited to cases involving a fiduciary’s conflict of interest (financial or otherwise). If one does not act in good faith in exercising *oversight* of corporate employees—far short of engaging in affirmative misconduct or trying to feather one’s nest—one necessarily is not acting loyally. The result: no potential exculpation under 102(b)(7); no chance for indemnification by the corporation for litigation costs, including legal expenses; and potentially no insurance coverage as well.

Procedural Implications

Stone poses two main procedural implications in the wake of its substantive rulings. First, a derivative

complaint may proceed against directors only in the rare instance in which a plaintiff can make a clear showing at the pleading stage that the directors *knew* they were not discharging their fiduciary obligations. This occurs in one of two instances: either “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system of controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.” Thus, in the absence of “red flags,” the sole relevant inquiry is whether the directors acted “to assure a reasonable information and reporting system exists.” As the court acknowledged, a claim that a director is subject to personal liability for employee failures is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”

Second, the court reaffirmed that, unless plaintiffs in a derivative lawsuit can show, using the rubric above, that the directors failed to act in good faith and therefore were not disinterested (because they could be subject to personal liability), plaintiffs will have failed to show they are excused from making a demand on the board, and their complaint will be dismissed for failure to plead demand futility with particularity. A “hindsight” showing that corporate employees engaged in bad acts causing corporate loss does not necessarily indicate the board failed to exercise oversight and, is not, without additional evidence that the board knew or consciously turned a “blind eye” to corporate employees’ activities, enough to meet the high pleading requirement for demand futility.

Practical Lessons

The *Stone* decision, combined with the recent *Disney* decision, suggests a continued trend by the Delaware Supreme Court toward deference in favor of outside directors in the absence of specific red flags. Directors who implement reasonable information systems and continue to monitor such systems can help to insulate themselves from liability. As we have iterated in the past, such practices include:

- ensuring appropriate company risk and financial systems and controls are in place;
- monitoring such systems and controls, generally on an annual basis, to ensure their continued effectiveness;
- reading all the materials given to them by management;
- reviewing public disclosures, filings, and releases;
- reading analysts’ reports;
- if necessary, asking management for additional information in order to have a better understanding of the company’s business and the risks it faces; and
- ensuring that the board’s audit committee communicates on a regular basis with the company’s outside auditors outside the presence of management.

Notes

1. 698 A.2d 959 (Del. Ch. 1996).
2. *Id.* at 968. See also *Ash v. McCall*, 2000 WL 1370341 (Del.Ch. 2000) (noting that board’s oversight duty is “a subset of the duty of care”); *Official Comm. of Unsecured Creditors v. Elkins*, 2004 WL 1949290 (Del.Ch. 2004) (failure to monitor claim is “a proper breach of duty of care claim”).
3. See *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 751 (Del.Ch. 2005) “The classic example that implicates the duty of loyalty is when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders.” [citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)].
4. See *Thorpe by Castleman v. Cerbco, Inc.*, 676 A.2d 436, 442.Supr. 1996), awarding a benefit to employees that directly benefits the directors who voted for the measure, *Nixon v. Blackwell*, 626 A.2d 1366, 1374 (Del. Supr. 1993), and engaging in a transaction that confers a financial benefit on a director which is unfair to the corporation, see *Mills Acquisition Co. v. MacMillan Inc.*, Del. Supr., 559 A.2d 1261, 1280 (1989).

BOARD OF DIRECTORS

Special Committees: A Primer

By John F. Grossbauer and Michael K. Reilly

For more than twenty years,¹ corporations have turned to special committees for their legal and practical benefits where a transaction, for one reason or another, may be tainted by the interest of a director, officer or controlling stockholder. For transactions involving a controlling stockholder or a conflicted board, a special committee provides certain legal benefits that protect both the transaction and the directors. In that context, an understanding of the general body of case law that has developed relating to the proper formation and functioning of special committees is critical to ensure that the transaction, and the directors, benefit from the use of the special committee. Even where a transaction does not involve a controlling stockholder, or where less than a majority of the directors are conflicted, a board may find a special committee, more properly referred to as a “transaction committee” in that context, to have certain practical advantages.

The Function and Purpose of Special Committees

A properly structured special committee process may provide a number of legal and practical benefits. The legal benefits created by the use of a special committee are inextricably tied to one of the most fundamental concepts of corporate law—the business judgment rule. As many of you know, directors must be disinterested and independent with respect to a matter at issue in order to be entitled to the protections of the business judgment rule. In the absence of a special committee or other “cleansing” mechanism, if a majority of the directors are not disinterested and independent, their decisions will not be accorded deference and they will be required to establish that the challenged transaction was “entirely fair” to the corporation and its stockholders.² In addition, if a transaction involves a

controlling stockholder, the transaction will be subject to the entire fairness standard of review *ab initio*, regardless of whether a majority (or all) of the directors are disinterested and independent.³ If a transaction involves a controlling stockholder or is one in which a majority of the board of directors has a disabling conflict of interest, a special committee provides important legal benefits.

Where a transaction involves a controlling stockholder, the primary legal benefit of the use of a special committee is to shift the burden of proving entire fairness from the defendant corporation and directors to the plaintiff stockholders.⁴ Burden shifting, however, is not the only benefit created by the use of an effective special committee in that context. Utilization of a special committee will also make it more difficult for a plaintiff to meet its burden of showing that the challenged transaction was unfair because, under an entire fairness standard of review, a court will consider how the transaction was structured and negotiated. Indeed, the utilization of a properly functioning special committee provides “powerful evidence of fairness.”⁵

Practice Pointers: In lieu of utilizing a special committee, the burden may be shifted by conditioning the transaction on a fully-informed vote of a “majority of the minority” of the outstanding voting power of the corporation.⁶ Given the aggressive tactics of hedge funds and the potential for those funds to obtain leverage by threatening to prevent a corporation from satisfying the “majority of the minority” condition, a special committee oftentimes is a more advisable mechanism to shift the burden of proof in a controlling stockholder transaction.⁷

Where a transaction does not involve a controlling stockholder, but where a majority of the board has a disabling conflict of interest with respect to the transaction, the utilization of a fully-functioning and effective special committee may give rise to the protections of the business judgment rule. Although the relevant case law is less than clear, the Delaware Supreme Court has not held that the business judgment rule is inapplicable in such a situation. Indeed, the Delaware Court of Chancery has expressed the view that the business

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judgment rule protections should be reinvoked in such circumstances.⁸

Absent a transaction involving a controlling stockholder or a conflicted board, the business judgment rule should still apply to any decision by a board of directors with respect to a particular transaction. A special committee, therefore, is not necessary to shift the burden of proving entire fairness or to re-invoke the business judgment rule. Nevertheless, a special committee, more accurately referred to as a “transaction committee” in such circumstances, may provide certain practical benefits.⁹ For example, the use of a transaction committee may provide for a more efficient process by empowering a committee of directors, rather than the entire board of directors, with the authority to approve a particular transaction (subject to applicable statutory limitations).¹⁰ Such efficiencies have been deemed to be important particularly where the consideration of the transaction will require intense director involvement and multiple meetings. Moreover, a committee may be useful as a mechanism for shielding conflicted directors, officers or advisors from the process. Thus, even where a committee is not necessary to provide the unique legal benefits recognized by Delaware law (*e.g.*, shifting the burden of proving entire fairness or re-invoking the protections of the business judgment rule), a transaction committee remains a useful corporate tool.

*Practice Pointers: A special committee should be utilized where a transaction involves a controlling stockholder or a majority conflicted board. A special committee also is recommended where there is only the appearance of a conflict, as the mere appearance of a conflict may be sufficient to invoke application of the entire fairness standard of review. Absent a controlling stockholder or majority conflicted board, a transaction committee may still be useful where it is deemed necessary or advisable to shield conflicted directors, officers or advisors from the process. Indeed, such transaction committees have been encouraged even outside of the Delaware courts, e.g., the SEC’s recent amendment of the tender offer best-price rules to provide a safe harbor for executive compensation arrangements that are approved by independent directors.*¹¹

The Prerequisites of an Effective Special Committee

In order to obtain the legal benefits of a special committee, however, it is critical for the committee

to be properly formed and to function effectively. The legal benefits resulting from special committee approval of a transaction will accrue only if the special committee is independent, active, informed, and has “real bargaining power.”¹² In that regard, a fully functioning and effective special committee should have the following attributes: (i) the committee members must be disinterested and independent; (ii) the committee members must understand their mandate; (iii) the committee must have real bargaining power; (iv) the committee must be informed and active; and (v) any advisors to the committee should be competent, disinterested and independent.

A. Selection of Committee Members

In determining the number and identities of the committee members, a board of directors should consider a number of factors, including (i) the total number of directors serving on the entire board, (ii) the time requirements associated with the special committee process and each director’s availability to meet those time commitments, (iii) whether a director has specific knowledge and/or expertise relevant to the issues that the committee will consider, and (iv) whether a director is disinterested and independent with respect to the particular matter and parties at issue.

*Practice Pointers: There are no hard and fast rules for determining the number of directors that should serve on a committee. Generally, a committee preferably should consist of at least three and not more than five directors. If it is anticipated that the committee’s mandate will require it to be in place for a long period of time, a greater number of committee members may be preferable as it may be difficult to attain a quorum of directors for multiple committee meetings occurring over many months. Alternatively, if the committee’s task is likely to require swift and immediate action, a smaller number of committee members may prove to be less cumbersome from a practical perspective.*¹³

In selecting the members of a special committee, care should be taken to ensure not only that the members have no financial interest in the transaction, but also that they have no financial ties, or are not otherwise beholden, to any person or entity involved in the transaction.¹⁴ In other words, all committee members should be independent and disinterested with respect to the particular transaction at issue. To be disinterested, the member cannot derive any personal benefit (or suffer a

detriment) from the transaction not shared by the stockholders.¹⁵ Even if a director does not derive a personal benefit (or suffer a detriment) from a transaction and is thus not technically interested in the transaction, a director still may be deemed incapable of making an independent judgment if the director lacks independence with respect to the particular transaction. Broadly defined, a director is considered independent if his or her “decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”¹⁶ In assessing independence, the courts often look to whether outside influences affect a director’s business judgment, such as whether the director is controlled by or beholden to another person or entity.

Practice Pointers: Whether or not a director is independent for purposes of serving on a special committee is a question distinct from the question whether a director is deemed to be independent for purposes of any stock exchange rules. Determining whether or not a director is independent for purposes of serving on a special committee requires a context-specific analysis. Mere receipt of director fees will not, in and of itself, raise questions about a director’s independence. Moreover, a personal friendship between an interested party and a director will not, standing alone, result in the director automatically being incapable of making an independent judgment with respect to a transaction. Furthermore, the mere fact that a stockholder has designated a director does not, standing alone, make that director beholden to the stockholder.

B. The Committee’s Mandate

A special committee’s mandate will be defined both by the resolutions adopted by the board when it created the committee and the specific circumstances the committee will face when negotiating a transaction. The challenge, ultimately, for counsel and the special committee is to ensure that the scope of the authorizing resolutions coincide with the fiduciary responsibilities of the special committee members in the specific context.

Practice Pointers: In certain recent decisions, the Delaware Court of Chancery has emphasized that it is critical for committee members to have a proper understanding of their mandate.¹⁷ If the members do not understand their mandate, a court may find that the committee process was flawed. It is, therefore, critical that counsel to the special committee ensures that the committee members understand (at the

beginning of the process) their mandate and the requirements for fulfilling their mandate.

C. The Committee’s Powers

An effective special committee charged to negotiate a transaction must have “real bargaining power.”¹⁸ In the nascent stages of the precedent that has since arisen around the use of special committees, the notion of “real bargaining power” was quite simplistic, requiring only that a special committee be vested with the power to veto the proposed transaction. While initially the Delaware courts seemed content to accept this limited charge as sufficient indicia of fairness in the process, that outlook ultimately was replaced by one that required far more in the way of special committee authority and performance in order to shift the entire fairness burden from a conflicted and controlling majority.

Accordingly, the actions of special committees have been scrutinized with increased judicial enthusiasm and the legal benefits of a special committee have been extended only upon a showing that the committee’s capacity and performance accurately approximated arm’s length negotiations. A special committee, therefore, should obtain sufficient power to take aggressive actions even against a controlling stockholder of a corporation. The Court of Chancery has gone so far as to suggest that a special committee should consider obtaining the power to adopt, and potentially implement, a rights plan against a controlling stockholder in appropriate circumstances.¹⁹ Although the Delaware Supreme Court has suggested that such aggressive tactics may be used against a controlling stockholder only in certain limited circumstances,²⁰ the case law indicates a clear expectation that a special committee must act aggressively both to obtain as much power as possible and to use that power to protect the interests of the minority stockholders and to fulfill its mandate.

Practice Pointers: Legal counsel for a special committee must carefully consider the board resolutions that provide the special committee with its powers and ensure that the board has provided the special committee with sufficient power to carry out its role as arm’s length negotiator. Although the power to negotiate is critical, it may also be necessary for the special committee to obtain certain other powers of the board in order to increase the leverage that the special committee may bring to bear. In any event, counsel for the special committee should be prepared to bargain

intensely with legal counsel for the corporation in order to attain the full panoply of powers that the special committee will need in the specific context.

D. Informed and Active

A committee with real bargaining power will not cause the burden of persuasion to shift unless the committee exercises that power in an informed and active manner. To be informed, the committee necessarily must be knowledgeable with respect to the company's business and advised of, or involved in, ongoing negotiations. To be active, the committee members should be involved in the negotiations or at least communicating frequently with the designated negotiator.

Practice Pointers: To the extent a transaction is challenged, a reviewing court will consider, among other factors, the process employed by the committee to negotiate the transaction. Accordingly, it is important for the committee to build a record demonstrating that it has engaged in a thorough and deliberate process, that the committee was fully-informed and that the committee actively fulfilled its obligations. A special committee should meet as often as necessary to faithfully discharge its fiduciary duties under the circumstances. While it may be prudent under certain circumstances for a committee to meet in person, as a general matter telephonic meetings are sufficient so long as each member of the committee can hear, and be heard by, the other members of the committee. The committee should, however, be cautious when outsiders are present, and should avoid the discussion of sensitive issues.

Retention of independent legal and financial advisors by the special committee also enhances its ability to be fully informed. Because of the short time frame of many of today's transactions, professional advisors allow the committee to assimilate large amounts of information more quickly and effectively than the committee could without advisors. Having advisors that can efficiently process and condense information is important where the committee is often asked to evaluate proposals or competing proposals within days of their making. It will often be appropriate for the committee's advisors to prepare presentations addressing certain issues. Any written work should be circulated in advance of the presentation, where possible. Once the committee has had sufficient time to digest the written material, the committee's advisors should be encouraged to

give a detailed presentation to the members of the committee so that the members of the committee are adequately informed before making their final decision.

The members should meet with their independent advisors as frequently as required in order to permit the members to acquire "critical knowledge of essential aspects of the [transaction]."²¹ Committee members may rely upon, and should interact with, and even challenge their financial and legal advisors. While reliance is often important and necessary, the committee should not allow an advisor to assume the role of ultimate decision-maker.²² The committee members should also be encouraged to ask questions of their advisors and to discuss alternatives to a proposed course of action.

In addition to its formal advisors, a committee may desire to invite "outsiders" to attend particular meetings. For example, there may be particular employees of the corporation who possess unique knowledge concerning the business or who can pull together relevant data and other information of interest to the committee.

Practice Pointers: It is also important, from a process standpoint, to keep accurate and contemporaneous minutes of each committee meeting. If a committee's decision is challenged, courts will give great weight to meeting minutes for purposes of developing the record. Indeed, minutes often provide the most reliable record of what the members of the committee considered and when they considered those issues. The minutes of the meeting at which specific action is taken by the committee should be detailed enough to show the deliberative process, the issues discussed and the specific action taken (including whether or not the action was unanimous). In advance of such a meeting, often it is appropriate for counsel to the committee to prepare draft resolutions for the committee's consideration. Those resolutions should contain recitals setting forth the salient background and factors supporting the committee's decision as well as the specific action taken, authorized or recommended by the committee.

E. Selection of Advisors

Although there is no legal requirement that a special committee retain advisors, it is highly advisable that it does so. The choice of advisors and the manner in which they are selected, however, may influence a court's determinations with respect to

the independence of the committee and the effectiveness of the process.

Selection of advisors should be made by members of the special committee and not by management of the company, general counsel, or the board. Although the special committee may rely on the company's professional advisors, a reviewing court's perception of the special committee's independence is enhanced by the separate retention of advisors who have no prior affiliation with the company or interested parties. Accordingly, the special committee should interview potential advisors to ensure that they have no prior or current, direct or indirect, material affiliations with the company or the interested parties. When analyzing the process, a Delaware court also is likely to consider whether the advisor's sophistication and expertise is appropriate for the engagement.

Practice Pointers: If management recommends the legal or financial advisors, the committee should take steps to ensure that the advisors are sufficiently disinterested and independent. The committee should also ensure that the advisors are sophisticated and have experience to merit advising the special committee in the particular context. Indeed, the Delaware courts have questioned the competence of legal advisors to special committees and found those questions to be relevant in determining whether the committee functioned properly, and thus whether the legal benefits of the special committee were obtained.²³

Importantly, a legal advisor to the special committee should not be actively representing the corporation, its officer or directors, or any party to the relevant transaction. Prior representations of the corporation may also raise an issue as to whether the legal advisor is independent.²⁴ The legal advisor should not have any other monetary or personal relationships with the corporation or its officers or directors of a type or level that may raise the suspicion that the legal advisor would somehow have an interest in seeing the special committee reach a particular result when it is considering a transaction. In addition, the legal advisor should provide an engagement letter to the special committee, setting out the scope of the legal advisor's representation.

As with the legal advisor, the special committee should retain a financial advisor who is experienced

in providing the particular advice that is required for the particular task at hand. The special committee should consider whether the financial advisor has the requisite expertise to provide the anticipated advice, is experienced in representing special committees, and has expertise in the industry (particularly if such expertise would be useful in advising the committee).

Practice Pointers: The legal advisor should assist the committee in approving an appropriate engagement letter with the financial advisor, which will set forth the anticipated scope of the financial advisor's duties and the fee structure. It is critical for the legal advisor to ensure that the scope of any fairness opinion to be provided by the financial advisor is appropriate in light of the special committee's mandate, and to ensure that the fee structure properly incentivizes the financial advisor to provide advice to the special committee that is in line with, and does not raise the potential for a conflict with, the special committee's mandate. In several recent cases, the Court of Chancery has emphasized the importance of ensuring that the financial advisor provides the proper advice to the special committee, particularly where there are two classes of stock at issue and thus where it is important for the special committee to determine not only the fairness of the transaction to a particular class of stock, but also the relative fairness of the transaction to one class of stock as it relates to another class of stock.²⁵

The special committee and its advisors should also consider whether it is appropriate and/or advisable to retain other advisors. Depending on the circumstances and the committee's mandate it may be possible that a special committee would benefit from the expertise of other advisors who may provide the committee with advice that is additional to the advice that would be provided by its legal counsel and financial advisor.

Conclusion

In today's litigious environment, special committees play an integral role in the approval of transactions where conflicts of interest may exist. In an attempt to avoid jeopardizing the successful consummation of a transaction and to minimize the risk to directors, many Delaware corporations turn to special committees for their legal and practical benefits. Although the benefits of special committees are

real, the challenges to properly forming a special committee and effectively running a special committee process are numerous. In forming a special committee, care must be taken to ensure that the members of the special committee are independent and disinterested, and that the special committee has the proper power to perform its duties. In running an effective committee process, care also must be taken to ensure that the special committee has access to independent advisors, becomes fully informed, and acts deliberately and aggressively, if necessary. Properly utilized, special committees not only minimize risk, but also maximize stockholder value in transactions by creating arm's length negotiations that help to generate a fair process and fair price.

Notes

1. The origin of the special committee as a structuring device to deal with fiduciary duty concerns can be traced back to the Delaware Supreme Court's landmark decision in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
2. See *Weinberger*, 457 A.2d at 710; *Williams v. Geier*, 671 A.2d 1368, 1378 (Del. 1996).
3. See *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1121 (Del. 1994).
4. See *id.*; *Emerald Partners v. Berlin*, 787 A.2d 85, 93 (Del. 2001).
5. *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 550 (Del. Ch. 2003).
6. See *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at 14-15 (Del. Ch. Aug. 18, 2006) (stating that, at least outside the controlling stockholder context, a vote of a majority of the *outstanding* minority, rather than a majority of the *voting* minority, could reinvoke the business judgment rule). The *PNB Holding* decision also suggests that a conflicted board's decision to enter into a transaction (absent a controlling stockholder) may be protected by the business judgment rule merely by obtaining a majority of the outstanding minority vote as a mathematical matter and without conditioning the transaction on the attainment of that vote. See *id.*
7. At least one Vice Chancellor of the Delaware Court of Chancery has suggested, contrary to settled Delaware law, that the utilization of both a fully-functioning and effective special committee and a fully informed vote of a "majority of the minority" should reinvoke the protections of the business judgment rule. See, e.g., *PNB Holding*, 2006 WL 2403999, at 14 n.71; *In re Cox Communications, Inc.*, 879 A.2d 604, 606 (Del. Ch. 2005).
8. See, e.g., *PNB Holding*, 2006 WL 2403999, at 14 n.69; *In re Western Nat'l Corp. S'holders Litig.*, 2000 WL 710192, at 26 (Del. Ch. May 22, 2000).
9. The term "transaction committee" is preferred in such circumstances in order to bolster the argument that the business judgment rule applies to the transaction. If the committee is referred to as a special committee, a plaintiff may argue that the corporation has conceded that the transaction is subject to the entire fairness standard of review.
10. Section 141(c) of the General Corporation Law of the State of Delaware, which governs the creation and authority of board committees, does not permit the board of directors to delegate to a committee the final authority to approve mergers, asset sales and other transactions requiring a stockholder vote. In such circumstances, the committee can be given full power to negotiate a transaction and the authority to determine whether the full board should consider the approval of the transaction.
11. Amendments to the Tender Offer Best-Price Rules, Release No. 34-54684 (Nov. 1, 2006) ("A special committee of the board of directors of the subject company or the bidder, as applicable, comprised solely of independent members and formed to consider and approve the arrangement may approve the arrangement and satisfy the safe harbor requirements if the subject company's or bidder's board of directors, as applicable, does not have a compensation committee or a committee of the board of directors that performs functions similar to a compensation committee or if none of the members of those committees is independent.").
12. *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997); see also *Cysive*, 836 A.2d at 548.
13. The Delaware courts place more trust in a multiple member committee, "than in a committee where a single member works free of the oversight provided by at least one colleague." *Gesoff v. IIC Industries, Inc.*, 902 A.2d 1130, 1146 (Del. Ch. 2006). If a single member committee is used, the Delaware courts have required the sole member "like Caesar's wife, to be above reproach." *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985); see also *Gesoff*, 902 A.2d at 1146 n.101.
14. See *In re Tele-communications, Inc. S'holders Litig.*, 2005 WL 3642727, at 10 (Del. Ch. Dec. 21, 2005, revised Jan. 10, 2006) ("*TCP*").
15. See, e.g., *Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002). Delaware courts have generally found that a director will have a disabling interest with respect to a particular transaction where the benefit (or detriment) is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its stockholders. However, whenever a director stands on both sides of the challenged transaction, he or she is deemed to have a conflict of interest, and a showing of materiality has not been required. See *id.*
16. *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).
17. See, e.g., *Gesoff*, 902 A.2d at 1146-47; *TCI*, 2005 WL 3642727, at 9.
18. *Kahn v. Tremont*, 694 A.2d at 429; see also *Cysive*, 836 A.2d at 548.

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19. See *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421, 431 (Del. Ch. 2002).
20. See, e.g., *Black v. Hollinger Int'l Inc.*, 872 A.2d 559, 567 n.16 (Del. 2005).
21. *Kahn v. Tremont*, 694 A.2d at 430.
22. See *TCI*, 2005 WL 3642727, at 10-11.
23. See *Gesoff*, 902 A.2d at 1151-52.

24. See, e.g., *Benchmark Capital Partners IV, L.P. v. Vague*, 2002 WL 31057462 (Del. Ch. Sept. 3, 2002) (addressing whether legal counsel who had met with a corporation to discuss its possible representation of a special committee should be disqualified for later representing an investor adverse to the corporation).

25. See, e.g., *TCI*, 2005 WL 3642727, at 13-14; *Levco Alternative Fund Ltd. v. The Reader's Digest Assoc., Inc.*, 2002 WL 1859064, at 2-3 (Del. Aug. 13, 2002).

SHAREHOLDER MEETINGS

The Frequency of Shareholders' Meetings for the Election of Directors: Let the States Set the Rules

By William K. Sjostrom, Jr.

Under both state corporate law and stock exchange listing standards, public corporations are required to hold annual shareholders' meetings for the election of directors. This rule reflects two distinct requirements: (1) A requirement that public corporations elect directors *annually*, and (2) a requirement that public corporations hold shareholders' meetings *annually*. Fulfilling these requirements results in significant annual expenditures by corporate America. Common wisdom is that these expenditures are justified because annual elections and meetings are an important part of corporate governance, or, put differently, the benefits outweigh the costs. My contention is that this is false—these annual requirements results in the waste of corporate resources, and because they overlap, strip the states of important flexibility in crafting corporate governance packages for public companies.

Two states have in fact done away with the annual requirement. Annual director elections and shareholders' meetings are now optional under Minnesota and North Dakota corporate law. For exchange listed corporations, however, relaxed state rules on these points are essentially irrelevant. Even if an exchange listed corporation were incorporated in Minnesota or North Dakota, it would still have to hold annual shareholders' meetings for the election of directors as required by exchange listing standards. Hence, I propose that these listing standards be abolished so that the states can set the rules. This would give effect to the approaches taken by Minnesota and North Dakota, but, more importantly, it would allow state "laboratories" to experiment with alternative rules with respect to the frequency of elections and meetings. Consequently, it would add another variable for consideration in connection with the various proposed corporate governance reforms (e.g., shareholder proxy access, proxy

contest reimbursement, majority voting) under debate, some of which may impact the propriety of annual elections and meetings.

Annual Director Election Requirement

The obvious justification for mandatory annual director elections is to provide a check on management. A central theme of corporate law is addressing the agency problem inherent in the separation of ownership from control at public corporations. The typical public corporation is collectively "owned" by numerous and dispersed shareholders but controlled by management. Because management generally owns only a small percentage of the corporation's stock but has a large human capital investment in the corporation, the interests of management and shareholders diverge. As a result, management may take action in its own best interest as opposed to the best interest of the shareholders. Management may, for example, allocate itself excessive compensation or other perquisites, engage in empire building, or shirk responsibility.

To address this agency problem, the board of directors is charged with monitoring senior executives. However, the board may become dominated by, or beholden to, the executive team and therefore shirk its monitoring responsibility. Thus, annual director elections, at least in theory, provide shareholders a means to monitor the monitors. Specifically they give shareholders the opportunity to oust an ineffective director or board thereby providing an indirect check on management.

The reality, however, is that the outcome of the vast majority of director elections is a foregone conclusion—the nominees selected by management win. This is because for most shareholders physical attendance at a shareholders' meeting is an inefficient use of time—either the site is geographically inconvenient, the shareholder's investment in the corporation represents a small percentage of a diversified portfolio, or both. Hence, most shareholders vote by proxy pursuant to proxy materials furnished by

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the corporation, and therefore the proxy card becomes the *de facto* ballot. Since the management controls the ballot, it controls the election. It selects a slate of nominees (typically the incumbent directors) equal to the number of director slots up for election and includes these names and only these names in the proxy materials. Hence, the candidates run unopposed.

SEC regulations do require a proxy card to provide a means by which shareholders can withhold authority to vote for the corporation's nominees. At the majority of corporations, however, the outcome of election is not impacted by how shareholders vote. This is because the default voting standard for the election of directors is plurality, and under a plurality standard, the candidates that receive the largest number of votes win. In an uncontested election, the only individuals who receive any votes are those listed on the corporation's proxy card and ballot. Since the number of names listed will equal the number of seats up for election, each listed person is guaranteed to be among the top (and only) vote getters and therefore guaranteed to be elected (assuming a quorum).

To be sure, a disgruntled shareholder (commonly referred to as an insurgent) can nominate additional candidates or an entire alternative slate. The corporation, however, has no obligation to include the insurgent's nominees on the corporation's proxy card. An insurgent can nonetheless launch a proxy contest whereby it independently solicits proxies from the corporation's shareholder. In such an event, shareholders would receive two sets of proxy materials—one set from the corporation and one set from the insurgent, thereby giving shareholders a choice of competing slates. However, proxy contests for the election of directors outside of the takeover context are extremely rare. During the period 1996-2004, insurgents launched proxy contests to install rival slates outside of the takeover context at only 108 companies, an average of 12 a year.¹

Several reasons have been put forth for the dearth of electoral proxy contests. The first is cost. A proxy contest will typically run an insurgent from \$5 million to \$10 million. While the board will use the corporate coffers to fund its proxy campaign, including fending off any insurgent challenge, an insurgent must fund its campaign out of its own pocket and will be reimbursed by the corporation

only if it wins. The tab is so high because the insurgent will not only have to prepare and mail proxy materials, but, as discussed below, will have to overcome shareholder apathy and other impediments. As a result, the insurgent will find it necessary to retain attorneys, investment bankers, public relations advisors, proxy solicitors, and financial printers. The fees of these professionals quickly add up. And an incumbent board does not sit idly by in the face of a proxy contest. It may initiate litigation against the insurgent alleging federal proxy rule violations. At the same time, the insurgent may have to initiate litigation against the corporation or inspector of elections to, for example, obtain access to corporate records or challenge the invalidation of proxy cards. Any such litigation will add to the insurgent's costs.

Although an insurgent's costs will likely be reimbursed by the corporation if it prevails, only 37 of the 108 electoral proxy contests launched outside of the takeover context during the period of 1996-2004 were successful. Hence, an insurgent will have to consider the benefits of victory in light of the probability of failure. Also relevant is the insurgent's ownership percentage of the target corporation. If an insurgent owns five percent of the target, it will capture only five percent of the increase in firm value resulting from the successful proxy contest notwithstanding the fact that it will have incurred and risked 100 percent of the cost. The other 95 percent of value will be conferred on the firms' other shareholders even though they funded none of the cost of the proxy contest. This "free-rider" problem discourages shareholders from launching proxy contests. Many shareholders will instead holdout for the opportunity to free ride on a fellow shareholder's proxy contest.

Interrelated with cost are collective action difficulties inherent in public corporation shareholder voting. In the face of a proxy contest, a rational shareholder will choose to become informed about an insurgent's slate only if the benefits of doing so outweigh the costs. Most shareholders will conclude that the opportunity cost of reading the insurgent's proxy statement exceeds the expected benefit of an informed vote. Therefore, they will rationally remain uninformed or apathetic and thus vote for the incumbents by default. Even if a shareholder concludes that the expected benefit of becoming informed outweighs the cost, he is still unlikely to act because of a free-rider problem. Realizing that his vote is not

likely to be outcome determinative, he will choose not to incur the cost of becoming informed. Instead he will try to free ride on the efforts of other shareholders and nonetheless capture the benefits of informed collective action.

Of course, other shareholders are likely to implement the same strategy and likewise remain uninformed. In such a case, no collective action will be taken and no benefits will be captured. Additionally, even if informed, many shareholders will be reluctant to vote for the insurgents. They may be suspicious of the insurgent's motives, uncertain as to whether the corporation will perform better under the insurgent's team, or simply subscribe to the axiom "better the devil you know than the devil you don't." Further, some institutional investors may be reluctant to vote against the incumbents because of business concerns. For example, a vote by an insurance company against an incumbent board will likely jeopardize any existing and future business with that corporation and will be poorly received by incumbents at other companies.

As a result of the above factors, most shareholders are predisposed to vote for the incumbents. The insurgents will not necessarily even get the votes of disgruntled shareholders. These shareholders are more likely to instead follow the "Wall Street Rule," *i.e.*, sell their shares prior to the vote. Doing so eliminates the need to incur information costs or assume risk with respect to the insurgent.

The bottom line is that an insurgent will face an expensive uphill battle in an electoral proxy contest. It will have to spend heavily to overcome rational shareholder apathy and other impediments, but based on the data cited above, its chance of success will be approximately one in three. Given an insurgent is only reimbursed if it prevails and then has to share the spoils with all other shareholders, it is likely that many would be insurgents do nothing or sell out instead of fighting. In this light, it is not surprising that so few electoral proxy contests are launched and that even fewer are successful.

The end result is that in the vast majority of cases the election of directors is a charade—incumbent victory is a foregone conclusion. Hence, justifying *annual* director elections as a check on management is misplaced. An annual charade simply provides no meaningful check on management.

To be sure, director elections are becoming more meaningful. Specifically, in the past year shareholders have successfully pressured numerous companies to adopt majority voting standards for the election of directors. Elections with majority voting may provide a stronger check on management as shareholders would have the power, at least in theory, to block the election of one or more management nominees without having to launch a proxy fight. Others have proposed that the check be further strengthened by requiring corporations to reimburse insurgents' proxy contest expenses or to include shareholder selected director nominees in their proxy materials (an issue the SEC will soon be revisiting). Even a strengthened check, however, does not support the mandatory requirement of annual director elections. The check, strengthened or otherwise, flows not from the frequency of director elections but from the possibility that shareholders could rise up at any given time and oust an incumbent board, if warranted. Further, increased meaningfulness may actually militate against annual elections. If elections were to become so meaningful that they evolve to political type campaigns, the resulting distraction and disruption is likely something we do not want to annually impose on management. As Professor Bebchuk of Harvard Law School recently put it, "there is no reason to assume that the optimal frequency of scheduled elections for directors is once a year."

Annual Shareholders' Meeting Requirement

There are three primary justifications for the annual shareholders' meeting requirement. The first is that the requirement affords shareholders an annual opportunity to present matters to the shareholder body. This is true, but not in the traditional sense. As discussed above, few shareholders actually attend these meetings, but a shareholder can nonetheless get a matter before the shareholder body by having it included in the corporation's proxy materials. This is because federal proxy rules require corporations to include qualified shareholder proposals in their proxy materials. Because the annual shareholders' meeting requirement causes public corporations to solicit proxies annually, it indirectly, as a result of the Federal proxy rules, affords shareholders an annual opportunity to present matters to the shareholder body.

A second justification is that the requirement provides shareholders with an annual opportunity to engage in deliberation with fellow shareholders and management. The obvious weakness with this justification is that again, few shareholders actually attend the meetings so there are not many people present to engage in deliberation. Further, the justification is simply not supported by corporate law. The board, not the shareholders, is charged with managing or overseeing the management of the corporation. The statutory model simply does not mandate shareholder input. This point is reinforced by recent changes to the Delaware General Corporation Law (DGCL). In 1997, the Delaware legislature amended DGCL Section 211(b) to specifically allow shareholders to elect directors by written consent in lieu of annual shareholders' meetings. Obviously, if a corporation seeks to elect directors by written consent, there will be no meeting and thus no opportunity for shareholder deliberation. In a similar vein, the Delaware legislature amended DGCL Section 211(a) in 2000 to allow for virtual shareholders' meetings held in cyberspace. The section does require that a corporation holding a virtual meeting "implement reasonable measures to provide stockholders a reasonable opportunity to participate in the meeting."² In that regard, however, the section specifically requires only that shareholders have "an opportunity to read or hear the proceedings of the meeting substantially concurrently with such proceedings."³ There is no specific requirement that the technology used for a virtual meeting afford shareholders an opportunity to communicate with the corporation or fellow shareholders. At least four other states have similarly amended their corporate codes in recent years to allow virtual shareholders' meetings.

A third justification is that the requirement provides shareholders with annual opportunity to confront management. Annual meetings certainly do provide shareholders with such an opportunity, and the possibility of confrontation could perhaps provide an additional check on management. In particular, members of management may be less inclined to engage in opportunistic behavior or shirk responsibility knowing that they may have to explain themselves to shareholders face-to-face and suffer the attendant embarrassment. But as with deliberation, this justification is not supported by corporate law. There is no corporate law requirement that any members of management actually attend the meeting (although since 2004, the

SEC's proxy rules have required corporations to disclose director attendance). Additionally, similar to deliberation, the amendments to the DGCL allowing the election of directors by written consent and virtual shareholders' meetings indicate that the Delaware legislature does not view confrontation opportunity as a purpose of annual shareholders' meetings. If a corporation elects directors by written consent in lieu of a meeting or holds a virtual meeting, there is no opportunity for confrontation.

More generally, none of these justifications really speak to requiring meetings annually. Yes, maybe corporations do need to provide an opportunity to present matters, deliberate and confront, but I see no reason why we need to require them to do so annually.

The Minnesota Approach

As the previous demonstrates, there is no strong justification for requiring annual director elections and shareholders' meetings. Two states, Minnesota and North Dakota, have in fact realized this and thus take a different approach. This part describes the approach taken by Minnesota (the North Dakota approach is basically the same).

Effective January 1984, Minnesota replaced the concept of annual director and shareholders' meetings with "regular" meetings of shareholders.⁴ Under this approach, a corporation is not required to hold a regular shareholders' meeting unless (1) the corporation has not done so for 15 months, and (2) a shareholder or group of shareholders holding at least 3 percent of the corporation's voting stock demands a meeting. If a regular meeting is called, a corporation is required to hold director elections at the meeting; if no regular meeting is called a corporation is not required to hold elections. The presumptive term of directors is indefinite and runs until the next regular meeting is called.

The beauty of the Minnesota approach is that it generally preserves the substance of all the justifications for annual director elections and shareholders' meetings discussed above while having the potential to eliminate the holding of meaningless elections and meetings. If an insurgent wants to take a run at ousting a board, it can demand a meeting and do so. The check on management provided by director elections is fully preserved because, as noted above, the

check does not come from the frequency of director elections but from the possibility that shareholders could rise up at any given time and oust an incumbent board. Likewise, a shareholder can demand a shareholders' meeting if he or she believes deliberation or confrontation with management in such a setting is warranted, feels it is necessary to present a matter to the shareholder body, or has some other reason. Absent a reason, however, no demand will be made and therefore the holding of meaningless elections and meetings will be avoided.

At the same time, a corporation is always free to hold regular shareholders' meetings even if not required to do so. For example, a corporation may view the meetings as an important part of investor or other stakeholder relations. The point is that the Minnesota approach leaves the choice to a corporation and its shareholders instead of dictating a one-size-fits-all rule that results in many, many meaningless elections and meetings and therefore the unnecessary waste of corporate resources. It is in the best interests of management *and* shareholders to avoid the time and expense of meaningless elections and meetings.

Reform Proposal

While I believe the Minnesota approach is clearly better than the current scheme, I do not call for its blanket adoption. Instead, my proposal is simple: exchange listing standards requiring annual director elections and shareholders' meetings should be abolished. This would give effect to the Minnesota approach, and it would allow the "laboratory" of state corporate law to experiment with alternative rules. Currently, there is little motivation for the states to experiment in the area. Regardless of what applicable state law says, an exchange listed corporation would still have to hold annual shareholders meetings for the election of directors. Abolishment would fully expose the issue to corporate federalism thereby allowing states to adopt a Minnesota or other type of approach. It would enable the market for corporate law to determine the best rule.

More importantly, abolishment would give states flexibility in crafting corporate governance packages. As mentioned above, various corporate governance reform proposals have been made recently to make the election of directors more meaningful. These include variations on shareholder

proxy access, majority voting, and proxy contest expense reimbursement. In connection with adopting one of these proposals, a state may determine it is no longer advisable to elect directors annually. For example, a criticism leveled against many of the proposed reforms is that they will lead to short-termism. Specifically, if directors face meaningful annual elections, management will focus on short-term results to the detriment of the corporation's long-term success. This is because the majority of shares of most public corporations are owned by institutional investors who generally focus on short-term performance.

Therefore, the thinking goes, to keep this shareholder base happy, management will likewise adopt a short-term focus to the detriment of the corporation's long-term success. Additionally, management will also likely spend even more money and time than under the current system in preparing for an annual meeting with meaningful elections because it will have to actively campaign for the incumbents and against the challengers. Hence, if a state were to experiment with one or more of the proposed reforms, one way to address these concerns would be to lengthen the time between director elections thereby decreasing their frequency. Under the current system, this would not be possible because of the overriding exchange listing standard requirement of annual director elections and shareholders' meetings.

Conclusion

The large majority of annual director elections and shareholders' meetings are meaningless and therefore a waste of time and money. One response could be to make them more meaningful. For example, shareholders could be allowed to annually include candidates on a corporation's proxy, management attendance at shareholders' meetings could be mandated; a convenient meeting location could be required, *etc.* But for what end? There simply is no need for shareholders to *annually* elect directors, engage in deliberation, present matters to other shareholders, or confront management. It is not the frequency of these events that is important but the possibility that they can be triggered when needed. The Minnesota approach eliminates the annual requirement but preserves the trigger—no shareholders' meeting for the election of directors is held unless shareholders or the corporation deems it necessary. Abolishing the exchange requirement to hold annual shareholders' meetings for the election

of directors would give effect to the approach and allow states to experiment with different approaches perhaps yielding an even better rule.

Notes

1. See Lucian A. Bebchuk, "The Myth of the Shareholder Franchise" (October 2005) at 10. Available at SSRN:

<http://ssrn.com/abstract=829804>. Most of these 108 companies were small. Only 17 had market capitalizations at the time of the proxy fight exceeding \$200 million, and 59 had market capitalizations at the time of the time of the proxy fight of \$50 million or less. See *Id.*

2. *Id.*

3. *Id.*

4. See MINN. STAT. ANN. § 302A.431, Subd. 1. (West 2004).

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