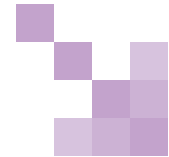


# United States



Stephen Giove, Matthew Musselman and Dorman Tong Yale\*  
Shearman & Sterling LLP

[www.practicallaw.com/5-385-6238](http://www.practicallaw.com/5-385-6238)

## CORPORATE ENTITIES

The vast majority of US public companies are organised as corporations. While many of the principles discussed below apply to private companies and to entities that are organised in forms other than the corporate form, the discussion below is limited to corporate governance rules applicable to, and the practices and principles of, US public companies. The focus is on federal securities law and Delaware law, as Delaware is the most common state of incorporation for companies.

References to the Top 100 US Companies refer to the companies surveyed in Shearman & Sterling LLP's 2008 Trends in Corporate Governance of the Largest US Public Companies (2008 S&S Corporate Governance Survey). This is available on request at [www.shearman.com/corporategovernance](http://www.shearman.com/corporategovernance).

Subject to certain exceptions, the top 100 US companies consist of the 100 largest US public companies (as ranked in Fortune magazine's Fortune 500 list, by revenue, as published in 2008) that have equity securities listed on the NYSE or Nasdaq.

## LEGAL FRAMEWORK

### 1. What is the regulatory framework for corporate governance and directors' duties?

Corporate governance practices and directors' duties are regulated by:

- Statutory law of the state in which the corporation is incorporated. Most US public companies are incorporated in the state of Delaware. The majority of other states base their legislation on Delaware law, or on the Model Business Corporations Act.
- Federal statutory law, including:
  - the federal securities laws, including the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (1934 Act);
  - regulations and other guidance promulgated by the Securities and Exchange Commission (SEC).
- Listing standards published by registered stock exchanges, most notably, the New York Stock Exchange Listed Company Manual (NYSE Listing Manual) and the National Association of Securities Dealers Automatic Quotation System Marketplace Rules (Nasdaq Marketplace Rules).
- Common law rules.

- The corporation's certificate of incorporation and bye-laws. Corporate governance guidelines and the charters of committees of the board of directors (board) also influence the corporation's governance.
- Shareholder activism and litigation, which often influences reform of corporate governance regulations and directors' duties.

## BOARD COMPOSITION AND REMUNERATION OF DIRECTORS

### 2. What is the management/board structure of a company? In particular:

- **Is there a unitary or two-tiered board structure?**
  - **Who manages a company and what name is given to these managers?**
  - **Who sits on the board(s)?**
  - **Do employees have a right to board representation?**
  - **Is there a minimum or maximum number of directors or members of the managerial and supervisory bodies?**
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- **Structure.** Corporations incorporated in the US overwhelmingly have a unitary board structure. Under most US state corporation statutes, the board members are elected for a term of one year. State laws commonly provide the option to institute a staggered or classified board, which ordinarily divides the members into three separate classes, with one class being elected annually to serve a three-year term. However, due to shareholder activism, classified boards have declined in popularity over the past few years, with only 27 of the Top 100 US Companies having classified boards in 2008 (*2008 S&S Corporate Governance Survey*).
  - **Management.** The corporation's board is responsible for appointing the corporation's management. The board typically delegates the day-to-day operation of the business to a chief executive officer (CEO) and other management employees. The senior managers of the corporation generally include the CEO, the chief financial officer (CFO) and the chief accounting officer (CAO), among others.
  - **Board members.** Members of the board are generally independent directors or members of senior management of the corporation, although some boards have members who are non-executive directors who are not independent (such as former senior

executives of the company). Subject to certain limited exceptions, the NYSE Listing Manual and the Nasdaq Marketplace Rules require a majority of the board members to be independent. In 2008, independent directors constituted 75% or more of the boards of 89 of the Top 100 US Companies. The CEO was the only non-independent director at 44 of those Top 100 US Companies (*2008 S&S Corporate Governance Survey*).

- **Employees' representation.** Employees are not entitled to board representation, and employee board members are nearly always executive officers.
- **Number of directors or members.** Most states do not require a minimum number of directors and leave the size of the board to be set by the corporation's certificate of incorporation or bye-laws. The corporation's certificate of incorporation usually sets the minimum and maximum number of directors that can constitute the board and provides that the exact number be set in the bye-laws or by a board resolution.

### 3. Are there any age or nationality restrictions on the identity of directors?

#### Age restrictions

There is no age limit imposed on directors of corporations, unless it is provided by the corporation's certificate of incorporation, bye-laws or corporate governance guidelines. However, 85% of the Top 100 US Companies have a mandatory retirement age for their non-employee directors. 32 of these companies permit exceptions to be made by the board or a board committee. Of these companies that have a mandatory retirement age, the majority impose a retirement age of 72. Common practice requires directors who are executives of the company to retire from the board when they retire from employment with the company (*2008 S&S Corporate Governance Survey*).

#### Nationality restrictions

Generally, there are no nationality restrictions on directors, although nationality may be relevant in some regulated industries. In addition, a director need not be a resident of the state in which the corporation is incorporated.

### 4. In relation to non-executive, supervisory or independent directors:

- **Are they recognised?**
- **Does a part of the board have to consist of them? If so, what proportion?**
- **Do non-executive or supervisory directors have to be independent of the company? If so, what is the test for independence or what makes a director not independent?**
- **What is the scope of their duties and potential liability to the company, shareholders and third parties?**

- **Recognition.** Federal securities laws require disclosure of the names of directors who are independent.

- **Board composition.** The NYSE and Nasdaq require the board to consist of a majority of independent directors. 52 of the Top 100 US Companies have adopted policies requiring more than a simple majority of independent directors (*2008 S&S Corporate Governance Survey*). State law does not place any restrictions on a board's composition.
- **Independence.** The NYSE has rules which determine whether a director may be considered independent. For example, to be considered independent, a director must not be, and must not have an immediate family member who is, an executive officer of the company within the past three years (*NYSE Listing Manual*).

The NYSE requires corporations to identify their independent directors and to disclose the basis for that determination. The Nasdaq Marketplace Rules also require identification of independent directors, but do not provide for disclosure of the basis of that determination. This disclosure is usually contained in the corporation's annual disclosures filed with the SEC.

The requirements for independence under the Nasdaq Marketplace Rules are similar to those under the NYSE Listing Manual, but there are some notable differences. One example is that under the Nasdaq Marketplace Rules, a director can be independent even if a relationship between the director and the corporation exists, as long as it would not interfere with the exercise of the director's independent judgement.

Both the NYSE and Nasdaq require that independent directors have regularly scheduled meetings, referred to as executive sessions, at which only independent directors or non-management directors are present.

- **Duties and liabilities.** Non-executive directors are generally subject to the same duties and liabilities as executive directors.

### 5. Are the roles of individual board members restricted? For example, can one person be the chairman and chief executive?

There are no legal restrictions on the combination of these roles and it is not unusual, especially in larger US public companies, for one individual to serve as both CEO and chairman. Proponents of good governance often tend to support the separation of these roles as a corporate governance best practice, and separation has become more frequent in recent years. In the current economic environment, it is probable that shareholders will be more likely to request that companies have an independent chairman to counter-balance the CEO's power.

Of the Top 100 US Companies in 2008, the roles of the chairman and the CEO were separated at 28 companies. Of the 28 Top 100 US Companies at which separate individuals serve as the chairman and the CEO, only eight have adopted explicit policies requiring the separation of the two roles (*2008 S&S Corporate Governance Survey*).

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## 6. How are directors appointed and removed? Is shareholder approval required?

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### Nomination of directors

Directors are generally nominated by the board. Companies listed on the NYSE must have a nominating or governance committee, composed entirely of independent directors, which identifies individuals qualified to become board members and recommends their nomination to the board. The Nasdaq has similar requirements, but does not require a formal committee.

Shareholders who wish to suggest nominees for director may do so by following the submission procedures disclosed in the corporation's proxy statement.

Activist shareholders may also wish to submit their own director nominees to a shareholder vote in what is referred to as a proxy contest. Currently, shareholders are allowed to conduct an election contest under the proxy rules and can recommend to other shareholders one or more director candidates. However, shareholders find this process cumbersome and costly as they must provide proxy materials to other shareholders at their own cost. Recently, the SEC adopted a rule that allows an issuer to exclude from the company's proxy materials any shareholder proposal nominating a director or relating to a procedure for such nomination that could result in an election contest (*Release No. 34-56914*).

### Election of directors

Directors are elected by shareholders at the annual meeting of shareholders. Under Delaware law, a corporation may choose to elect its directors by a plurality vote of shares present in person or represented by proxy at the meeting. However, there has been a movement towards adoption of a majority voting standard for election of directors.

The intense pressure from shareholders on the subject of voting standards in director elections has resulted in a dramatic increase in the number of companies adopting a majority vote standard. 71 of the Top 100 US Companies now require directors to be elected by a majority of the votes cast (*2008 S&S Corporate Governance Survey*).

### Removal of directors

State law and the corporation's certificate of incorporation and bye-laws set out the methods for removal. Generally, directors can be removed by the corporation's shareholders or by judicial proceedings. Shareholders can usually, by a sufficient vote, remove any director or the entire board with or without cause, although removal of directors where the board is staggered may be subject to different rules.

Vacancies can generally be filled by a majority of the directors then in office, even if there are fewer directors than the quorum. A company's certificate of incorporation and bye-laws may also permit shareholders to fill vacancies.

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## 7. Are there any restrictions on a director's term of appointment?

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While Delaware's General Corporation Law allows the certificate of incorporation or bye-laws to prescribe various qualifications for directors, including the term of appointment, term limits for directors are relatively uncommon.

Although 70 of the Top 100 US Companies discuss the topic of term limits for directors in their proxy statements, only four have adopted mandatory term limits (*2008 S&S Corporate Governance Survey*). The most common rationale provided by companies for not adopting mandatory term limits is the value of the insight offered by directors who have extensive board service.

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## 8. Do directors have to be employees of the company? Can shareholders inspect directors' service contracts?

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### Directors employed by the company

Directors do not have to be employees of the corporation. In fact, under the NYSE and Nasdaq listing standards, a majority of the board must be comprised of independent directors. In order to be considered independent, the director cannot be, nor have been within the last three years, an employee of the corporation.

### Shareholders' inspection

Federal securities law requires extensive disclosure concerning directors' compensation arrangements, as well as related party transactions between the directors and the corporation. Public companies must disclose material transactions that exceed US\$120,000 (about EUR93,699) between the company and certain related parties, which include the following:

- Officers.
- Directors.
- Director nominees.
- 5% or greater beneficial owners.
- The respective immediate family members of the above mentioned.

In addition, public companies must provide disclosure regarding their policies and procedures used in reviewing and approving such related party transactions.

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## 9. Are directors allowed or required to own shares in the company?

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Directors are not required by law to own shares in the corporation. However, the corporation's certificate of incorporation, bye-laws or adopted policies may require the director to own a minimum number of shares. Share and stock option ownership by directors is often encouraged to align the directors' own interests with those of the corporation's other shareholders.

If a director owns publicly traded shares, they must (§16, 1934 Act):

- Disclose to the public his holdings of equity securities, the trading of those shares and the receipt of stock options.
- Not deal in those shares in certain circumstances.

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#### 10. How is directors' remuneration determined? Is its disclosure necessary? Is shareholder approval required?

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##### Determination of directors' remuneration

Generally, unless otherwise restricted by the corporation's certificate of incorporation or bye-laws, the board can set the directors' compensation, subject to its common law fiduciary duties. This compensation may include cash, the corporation's shares or options on, or other derivatives of, the shares.

##### Disclosure

Public companies are required by the federal securities laws to disclose their directors' remuneration in any proxy statement or annual report filed by the corporation with the SEC. There are separate requirements relating to disclosure of share ownership.

In order to ensure that investors receive the most complete and accurate description of a corporation's director and executive compensation practices, the SEC adopted new disclosure rules in late 2006. The rules require enhanced disclosure regarding payments to executives and directors. The rules also require a corporation to include a new section entitled Compensation, Discussion and Analysis (CD&A) in its disclosure documents. The CD&A is a statement from the corporation and its management on its policies and decisions on executive compensation.

##### Shareholder approval

Shareholder approval of directors' cash compensation is not typically required. Shareholder activists often propose mandatory shareholder approval of executive remuneration as a corporate governance reform. The NYSE Listing Manual and the Nasdaq Marketplace Rules require shareholder approval of equity remuneration plans covering directors.

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#### MANAGEMENT RULES AND AUTHORITY

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#### 11. How is a company's internal management regulated? For example, what is the length of notice and quorum for board meetings, and the voting requirements to pass resolutions at them?

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A corporation's certificate of incorporation and bye-laws typically regulate internal management of the corporation and where these documents are silent, state law provides default rules.

Under Delaware corporate law, a majority of the total number of directors constitutes a quorum, and a vote of the majority of the directors present at a meeting at which a quorum is present is required to take any valid actions. However, these requirements

can be altered by the certificate of incorporation or bye-laws, with certain restrictions. The directors can also take valid actions without a meeting (that is, by written consent), unless the certificate of incorporation or bye-laws provide otherwise.

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#### 12. Can directors exercise all the powers of the company or are some powers reserved to the supervisory board (if any) or a general meeting? Can the powers of directors be restricted and are such restrictions enforceable against third parties?

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##### Directors' powers

State corporate law and the corporation's certificate of incorporation typically provide that the board can exercise all of the corporation's powers. However, certain actions and transactions require shareholder approval under state corporate law, such as mergers and amendments to the certificate of incorporation.

##### Restrictions

The board's powers can be restricted by the corporation's certificate of incorporation or bye-laws, and are subject to statutory limitations.

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#### 13. Can the board delegate responsibility for specific issues to individual directors or a committee of directors? Is the board required to delegate some responsibilities, for example for audit, appointment or directors' remuneration?

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State statutory law and a corporation's certificate of incorporation normally expressly provide that the board can delegate any of its powers to an individual director or to a committee of directors. However, many state corporation statutes restrict the scope of the activities that may be conducted by a committee of less than an entire board.

Under Delaware law, a duly appointed committee has all the powers delegated to it by the full board (or provided for in the certificate of incorporation or bye-laws) other than the power to (§141, *Delaware General Corporation Law*):

- Amend the corporation's certificate of incorporation or bye-laws.
- Adopt certain agreements of merger or consolidation.
- Recommend to shareholders the sale, lease or exchange of all or substantially all of the corporation's property and assets, or the dissolution of the corporation or a revocation of a dissolution.
- Declare a dividend or to authorise the issuance of stock, unless otherwise permitted by the corporation's certificate of incorporation, bye-laws or resolution.

Although no particular committee structure is designated by state law, the US federal securities laws require public corporations to have an audit committee composed entirely of independent directors (§10A(m)(3), 1934 Act). The audit committee is responsible for the appointment, compensation and oversight of

the independent public accounting firm employed to audit the corporation's financial statements. The NYSE and Nasdaq also require that listed companies have an audit committee. In addition to an audit committee, the NYSE requires its listed companies to have a nominating or corporate governance committee and a compensation committee. Subject to certain exceptions, all of these committees must consist only of independent directors.

## DUTIES AND LIABILITIES OF DIRECTORS

### 14. What is the scope of a director's duties and personal liability to the company, shareholders and third parties? Please distinguish between civil and criminal liability under each of the following (if relevant):

- **General duties.**
- **Theft and fraud.**
- **Securities law.**
- **Insolvency law.**
- **Health and safety.**
- **Environment.**
- **Anti-trust.**
- **Other.**

- **General duties.** Directors owe the corporation and its shareholders a:
  - **Duty of care.** This generally requires that a director pay attention, ask questions and act diligently in order to become and remain fully informed and to bring relevant information to the attention of other directors;
  - **Duty of loyalty.** This generally requires that a director make decisions based on the corporation's best interest, and not on any personal interest.

In determining whether a board of directors has satisfied its fiduciary duties, the courts generally apply the business judgement rule under which a board's decision is protected unless it is shown that the directors breached their duty of care or duty of loyalty.

Negligence on the part of a director does not result in personal liability unless the director failed to act in good faith.

Directors' decisions may be more strictly scrutinised with respect to certain transactions, including the sale or change of control of the corporation or in conflict of interest situations.

- **Theft and fraud.** A director can be criminally liable under both federal and state laws regulating theft and fraud. In addition, directors can be held liable under other federal statutory schemes.

- **Securities law.** Directors of public corporations can be held both civilly and criminally liable under state and federal securities laws. In particular, directors cannot trade in a corporation's securities when in possession of material, non-public information (*Rule 10b-5, 1934 Act*). The federal securities laws also impose liability on directors for intentional or reckless misrepresentations or material omissions made in offering documents or proxy solicitations.
- **Insolvency law.** In recent years many courts and commentators have analysed whether the directors of a corporation that is possibly insolvent (or in the zone of insolvency) or actually insolvent owe their fiduciary duties to the corporation's creditors. The Delaware Supreme Court recently held that where a corporation is in the zone of insolvency or clearly insolvent, the directors have a fiduciary duty to exercise their business judgement in the best interests of the corporation and do not owe any direct fiduciary duty to the corporation's creditors (*North American Catholic Education Programming, Inc v Gheewalla, 930 A.2d (Del 18 May, 2007)*). Creditors of an insolvent Delaware corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties but "have no right to assert direct claims for breach of fiduciary duty against corporate directors" (*Id*). Creditors can also bring direct non-fiduciary claims under contract, tort, fraudulent conveyance and bankruptcy theories and to enforce any security interests collateralising their claims.
- **Other.** Directors are potentially personally liable under various federal statutory schemes in areas such as health, safety, the environment and anti-trust.

The Foreign Corrupt Practices Act of 1977 (FCPA) targets corrupt payments made by corporations to certain foreign officials. Directors may be criminally liable for knowing violation of the statute. The FCPA prohibits a company from indemnifying its directors and officers for fines under the FCPA.

### 15. Can a director's liability be restricted or limited? Is it possible for the company to indemnify a director against liabilities?

#### Limiting director liability

Most states allow a corporation to eliminate or limit directors' personal liability to the corporation or its shareholders for breach of their fiduciary duty. However, there are often restrictions on this limitation of directors' liability. For example, Delaware law provides that directors' liability cannot be eliminated or limited for:

- Any breach of the director's duty of loyalty.
- Acts or omissions not in good faith or involving intentional misconduct.
- Wilful or negligent conduct in paying dividends.
- Any transaction from which the director derives an improper personal benefit.

Corporations often adopt provisions in their certificates of incorporation eliminating directors' liability to the fullest extent permitted by law.

## Indemnification

All states have indemnification statutes. Under Delaware law, any person made a party to proceedings for being the corporation's director is entitled to indemnification, provided that the individual both:

- Acted in good faith.
- Reasonably believed that he acted in the corporation's best interests.

Indemnification is mandatory if the director is successful in the proceedings. Indemnification statutes often have restrictions (for example, a corporation cannot normally indemnify a director against liabilities owed to the corporation). Many corporations also provide contractual indemnities to their directors, in addition to the indemnification provided by the certificate of incorporation.

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### 16. Can a director obtain insurance against personal liability? If so, can the company pay the insurance premium?

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Directors can generally obtain insurance for wrongful conduct to cover any error, misstatement, misleading statement, act, omission, neglect or breach of duty. In addition, because one of the most serious concerns for officers and directors are the legal fees associated with frivolous claims, insurance also covers the legal fees from a criminal proceeding or any formal civil administrative or regulatory proceeding (except taxes, fines or penalties imposed by law). Public companies purchase this insurance on behalf of the directors. Insurance cannot be purchased to protect directors against liability based on the director's fraud, dishonesty or violations of criminal law.

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### 17. Can a third party (such as a parent company or controlling shareholder) be liable as a de facto director (even though such person has not been formally appointed as a director)?

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A shareholder's liability is normally limited to the amount of its investment in a corporation. However, where the corporate form is misused, most typically for fraud, the courts can pierce the corporate veil, and controlling shareholders may be held liable for the corporation's obligations. Generally, the courts only pierce the corporate veil for closely-held corporations. Shareholders who hold a controlling interest may have liability under the federal securities laws. Shareholders who hold a controlling interest may also be deemed to owe a fiduciary duty to minority shareholders. Controlling shareholders may be liable if they cannot demonstrate the objective fairness of a transaction, such as a merger or sale transaction which eliminates the interests of minority shareholders.

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## TRANSACTIONS WITH DIRECTORS AND CONFLICTS

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### 18. Are there general rules relating to conflicts of interest between a director and the company?

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The duty of loyalty requires a director to act in the best interests of the corporation and not for personal profit or gain or for other

advantages which do not benefit the corporation. A director can be held liable to the corporation if he allows an actual or potential conflict between his personal interests and the best interests of the corporation to obscure his ability to make decisions objectively.

Under the corporate opportunity doctrine, where a business opportunity becomes known to a director due to his position with the corporation, the director owes a duty to the corporation not to use that opportunity or knowledge for his own benefit.

Self-dealing transactions are voidable under common law, but many states have safe harbour statutes (for example, §144(a) of the Delaware General Corporation Law) that generally provide that a transaction is not voidable if either:

- It is approved by either informed or disinterested directors or shareholders.
- The transaction is fair to the corporation.

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### 19. Are there restrictions on particular transactions between a company and its directors?

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Section 402 of the Sarbanes-Oxley Act prohibits directors from receiving personal loans or extensions of credit from the corporation, with limited exceptions. Also, certain transactions between a company and its directors could impair director independence if the transactions are deemed to be a material relationship. Under the NYSE Listing manual, a director is not independent if a material relationship between the corporation and a director exists.

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### 20. Are there restrictions on the purchase or sale by a director of the shares and other securities of the company he is a director of?

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Generally, there are no restrictions on the purchase or sale of securities by a director of a public corporation, other than:

- Restrictions in relation to insider trading. A director cannot trade in corporation shares if he possesses material non-public information about the corporation. In addition, corporations usually have policies which regulate trading by officers and directors.
- Restrictions on trading during certain black-out periods tied to the corporation's pension fund.
- Restrictions on public resale of restricted and control securities in accordance with Rule 144 under the US federal securities laws. Rule 144 allows public resale of restricted and control securities if certain conditions are met, including:
  - a holding period requirement;
  - a current public information requirement;
  - a volume limitation;
  - a manner of sale condition;

- a brokers transaction requirement;
- the notice of proposed sale filed with the SEC on Form 144.

Directors must disclose their holdings of shares and share options to the public, along with any transactions that result in a change in their holdings (*§16, 1934 Act*). In addition, when a director acquires more than 5% of the corporation's shares, certain additional disclosures must be made (*§§13(d) and (g), 1934 Act*).

## DISCLOSURE OF INFORMATION

### 21. Do directors have to disclose information about the company to shareholders, the public or regulatory bodies?

There are various disclosure obligations relating to public companies, including:

- Disclosures required by periodic and current reports as prescribed by the 1934 Act and related guidelines of the SEC. Section 16 of the 1934 Act and related guidelines require that directors disclose information on beneficial ownership and changes in beneficial ownership. Certain activities by a corporation, such as sales of securities, stock repurchase programmes and grants under executive compensation plans may prompt disclosure obligations. In addition, corporations must disclose changes in board membership to the public.
- Extensive disclosure requirements when the corporation offers shares or other types of its securities to the public, as prescribed by the 1933 Act and related guidance of the SEC.

## COMPANY MEETINGS

### 22. Does a company have to hold an annual shareholders' meeting? If so, when? What issues must be discussed and approved?

All public companies must hold an annual meeting of shareholders. Under Delaware law for example, unless directors are elected by written consent in lieu of an annual meeting, an annual meeting of stockholders must be held for the election of directors (*§211(b), Delaware General Corporation Law*). Meetings are generally held in a manner provided for in the certificate of incorporation or bye-laws, and if not so designated, as determined by the board. Most corporations' certificates of incorporation do not set out specific issues that must be dealt with at a meeting, with the exception that all companies require directors to be elected at the annual meeting.

The 1934 Act requires a corporation to provide information to shareholders before the annual shareholders' meeting in the form of a proxy statement. Proxy statements typically solicit shareholder votes on the election of directors, ratification of the corporation's independent accountants, and often on the approval of stock option plans related to executive compensation. A proxy statement may also include activist shareholder proposals.

### 23. Can shareholders call a meeting or propose a specific resolution for a meeting? If so, what level of shareholding is required to do this?

Generally, state statutes provide that shareholders can call special meetings if the corporation's organisational documents allow them to do so. With proper notice, shareholders' can generally make proposals at annual and special shareholders' meetings, but the corporation is not required to accept certain proposals.

## MINORITY SHAREHOLDER ACTION

### 24. What action, if any, can a minority shareholder take if it believes the company is being mismanaged and what level of shareholding is required to do this?

A minority shareholder can:

- Bring a claim, either on behalf of the corporation (referred to as a derivative action) or as a shareholder class action, against the corporation's directors for breach of fiduciary duty.
- Call a special meeting of shareholders if the corporation's certificate of incorporation allows.
- Submit shareholder resolutions to the board.
- Engage the corporation in a proxy contest in an attempt to replace the board and the corporation's management.
- Use any other grievance methods provided for in the corporation's certificate of incorporation or any shareholders' agreement.

## INTERNAL CONTROLS, ACCOUNTS AND AUDIT

### 25. Are there any formal requirements or guidelines relating to the internal control of business risks?

The rules adopted by the SEC under Section 404 of the Sarbanes-Oxley Act impose formal requirements relating to the corporation's internal control over financial reporting (which is a part of the corporation's internal controls). For every public corporation, the annual report required to be filed with the SEC must contain an internal control report:

- Stating the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
- Identifying the framework used by management to evaluate the effectiveness of the corporation's internal control over financial reporting.
- Containing an assessment, as of the end of the most recent fiscal year of the corporation, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

- The corporation's independent auditor is required to issue an attestation report on the corporation's internal control over financial reporting.

The SEC regulations also require quarterly reports to discuss changes in internal controls over financial reporting. In addition, the CEO and CFO must annually and quarterly provide certifications which relate, in part, to internal controls over financial reporting.

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#### **26. What are the responsibilities and potential liabilities of directors in relation to the company's accounts?**

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Any director who makes or causes the making of any false or misleading statement in a document filed with the SEC can be held personally liable for the misstatement, including those made in connection with the corporation's accounts (*§§11 and 12, 1933 Act and Rule 14c-6, 1934 Act*).

In the context of securities offerings, every director of the issuer corporation at the time of filing the registration statement can be held personally liable for any untrue statement of a material fact or omission of a material fact required to be stated therein or necessary to make the statements therein not misleading (*§11, 1933 Act*). Similarly, every director of the issuer corporation can be held personally liable for use of a prospectus which includes any untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading (*§12, 1933 Act*).

A director can avoid liability by proving that he had acted in good faith and with lack of knowledge. Under the Sarbanes-Oxley Act, directors can also face criminal liability for fraudulently influencing, coercing or misleading an accounting firm during an audit, with the intention of rendering the audit report misleading (*Rule 13b-2-2(b)(1), 1934 Act*).

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#### **27. Do a company's accounts have to be audited?**

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The annual financial statements of public companies must be audited by a registered independent accounting firm. Interim financial statements are not required to be audited but are required to be formally reviewed under applicable accounting literature.

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#### **28. How are the company's auditors appointed? Is there a limit on the length of their appointment?**

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If the corporation is a public company, the corporation's audit committee is responsible for hiring an independent registered public accounting firm as its auditor. The auditor must then be pre-approved by the entire board and the retention of the firm is often put before the shareholders for ratification. The federal securities laws provide that the accounting firm rotate the lead accounting firm partner responsible for co-ordinating and reviewing the corporation's audit every five years.

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#### **29. Are there restrictions on who can be the company's auditors?**

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A public company's auditors must be independent under the federal securities laws and the rules of the Public Company Accounting Oversight Board (PCAOB). Auditors of public corporations must also be registered with the PCAOB. Certain relationships can disqualify an auditor from being independent. For example, it is unlawful for a registered public accounting firm to perform an audit if a CEO, controller, CFO, CAO, or any person serving in an equivalent position for the corporation, was employed by that registered public accounting firm and participated in any capacity in the audit of the corporation during the one-year period before the initiation of the audit.

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#### **30. Are there restrictions on non-audit work that auditors can do for the company that they audit accounts for?**

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Federal securities laws prohibit a corporation's auditors from performing certain services for their audit clients. The following are prohibited non-audit services:

- Bookkeeping or other services related to the accounting records or financial statements.
- Financial information systems design and implementation.
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports.
- Actuarial services.
- Internal audit outsourcing services.
- Management functions or human resources.
- Broker or dealer, investment adviser or investment banking services.
- Legal services and expert services unrelated to the audit.
- Tax services during the audit engagement period to a person (or an immediate family member) in a financial reporting oversight role at an audit client generally.
- Any other service that the PCAOB determines, by rule, is impermissible.

All other non-audit activities must be approved in advance by the corporation's audit committee.

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#### **31. What is the potential liability of auditors to the company, its shareholders and third parties if the audited accounts are inaccurate? Can their liability be limited or excluded?**

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Generally, auditors in the US may not limit their liability because such limitations are viewed as impeding their independ-

ence. It may, however, be possible for auditors to limit in the engagement letter the punitive damages a client can claim.

As to third parties, an auditor can be held liable for negligent misrepresentation to third persons who are known to the auditors and for whose benefit the auditor provided the audit report.

An auditor can be liable to shareholders for statements made either (*§ 10(b), 1934 Act*):

- In the audit or internal control opinion.
- In the context of a securities offering by a corporation, under section 11 of the 1933 Act, based on the financial statements and attestation to the corporation's internal controls included in the corporation's registration statement.

Under section 11, the due diligence defence is available if the auditor can prove that after reasonable investigation, the auditor had reasonable grounds to believe and did believe, at the time, that the information in the registration statement was true and that there was no omission of a material fact required to be stated therein or necessary to make the statements therein not misleading.

## CORPORATE SOCIAL RESPONSIBILITY

**32. Is it common for companies to report on social, environmental and ethical issues? Please highlight, where relevant, any legal requirements or non-binding guidance/best practice on corporate social responsibility.**

Public companies often highlight their achievements related to social and ethical responsibilities in their annual report. These disclosures are driven more by best practices rather than legal requirements. There are more extensive disclosure requirements relating to environmental matters. For instance, recent actions taken by the New York State Attorney General will likely influence companies to include more disclosure on greenhouse gas emissions and climate change risks. A corporation must also disclose certain shareholder proposals, legal proceedings and other material corporate matters, which can include items relating to social responsibility.

## ROLE OF COMPANY SECRETARY

**33. What is the role of the company secretary in corporate governance?**

The company's general counsel (or an assistant counsel) is often also the company secretary and in this capacity will attend board meetings, prepare minutes of the meetings and maintain corporate records, among other things.

## ROLE OF INSTITUTIONAL INVESTORS AND SHAREHOLDER GROUPS

**34. How influential are institutional investors and other shareholder groups in monitoring and enforcing good corporate governance? Please list any such groups with significant influence in this area.**

Institutional investors and other shareholder groups have become influential in monitoring and enforcing their views of best practices in corporate governance. Many large investors have established corporate governance guidelines that they want corporations in which they invest to follow. Several of these investors, such as California Public Employees Retirement System and the Teachers Insurance and Annuity Association College Retirement Equities Fund, have published these guidelines on their websites. In addition, there are institutional advisory firms, such as Risk-Metrics Group and Glass, Lewis & Co, LLC which recommend how shareholders should vote on matters proposed to shareholders in corporations' proxy statements. Also, traditional shareholder activists, such as large pension funds, continue to be a powerful influence in shaping the climate of corporate governance and are often successful in encouraging corporations to adopt their desired practices. Such institutional investors often submit shareholder proposals in corporate governance policies. Finally, institutional shareholders and hedge funds are increasingly engaging corporations in discussions of their perspectives on matters affecting the corporation, such as capital structure, use of capital, strategic investments and acquisitions.

## WHISTLEBLOWING

**35. Is there statutory protection for whistleblowers (persons who disclose criminal activity or other serious malpractice within a company)?**

Boards of public companies, and in particular their audit committees, must establish procedures to enable employees to confidentially and anonymously submit concerns they might have in relation to the corporation's accounting, internal controls or auditing matters. Under the Sarbanes-Oxley Act, companies are subject to potential civil, and in some cases criminal, liability if they can be shown to have taken retaliatory action against an employee whistleblower.

## REFORM

**36. Please summarise any impending developments or proposals for reform.**

As discussed more fully in the 2008 S&S Corporate Governance Survey, shareholder activists have recently focused particular attention on efforts to persuade corporations to:

- Adopt a policy to separate the roles of CEO and chairman.

- Adopt majority voting for the election of directors and majority voting bye-laws that cannot be amended without shareholder approval.
- Declassify their boards so that all directors are elected on an annual basis.
- Eliminate all supermajority voting requirements, except where required by law, and adopt a simple majority voting standard.
- Require shareholder approval for certain actions, including the adoption or renewal of shareholder rights' plans.
- Adopt certain compensation-related measures, including the adoption of policies:
  - allowing a non-binding advisory resolution that ratifies the compensation for certain named executive officers disclosed in the proxy;
  - establishing a limit on total compensation for the CEO;
  - requiring that a significant portion (generally 75%) of future equity grants to employees be performance-based;
  - mandating clawbacks of compensation paid in certain circumstances.

In addition, as a result of general economic conditions in 2008, the US government became a shareholder and otherwise infused capital in certain institutions, and in these institutions, the US government is requiring that executive compensation meet certain standards.

To encourage the use of technological advances as an alternative means for discussion of shareholder issues, the SEC has proposed use of an online forum for shareholders to discuss matters among themselves on a real-time basis. In addition, the SEC is facilitating the establishment of online electronic shareholder discussion forums by clarifying that a corporation will not be liable for independent statements by shareholders on a company's electronic shareholder forum (*Release No. 34-57172*).

*\*The authors would like to thank Samara Abrams of Shearman & Sterling LLP for her assistance with this article.*

#### CONTRIBUTOR DETAILS

**Stephen Giove, Matthew Musselman and Dorman Tong Yale**  
**Shearman & Sterling LLP**  
**T** +1 212 848 4000  
**F** +1 212 848 7179  
**E** [sgiove@shearman.com](mailto:sgiove@shearman.com)  
[mmusselman@shearman.com](mailto:mmusselman@shearman.com)  
[dorman.yale@shearman.com](mailto:dorman.yale@shearman.com)  
**W** [www.shearman.com](http://www.shearman.com)

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