Corporate governance and directors' duties

An overview

Stephen Giove, Fabiana Sakai, Matthew Musselman and **Dorman Tong** of **Shearman & Sterling LLP** discuss directors' duties and the corporate governance practices of US public companies.

Illustration: Getty Images

The vast majority of US public companies are organised as companies. Their corporate governance practices and directors' duties are governed by:

- Statutory law of the state of incorporation. 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 (MBCA).

- Federal statutory law, including:

- the federal securities laws, including the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act); and

- regulations and other guidance promulgated by the Securities and Exchange Commission (SEC).

- Listing standards published by national registered securities exchanges, most notably, the New York Stock Exchange Listed Company Manual (NYSE Listing Manual) and the National Association of Securities Dealers Automatic Quotation System Mar-

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ketplace Rules (NASDAQ Marketplace Rules).

- Common law rules.
- The company's certificate of incorporation and by-laws as well as corporate governance guidelines and the charters of committees of the board of directors (board) (*see box "Shareholder groups"*).

Against that background, this article looks at:

- Board composition and compensation.
- Management rules and authority.
- Directors' duties and liabilities.
- Shareholder relations.

BOARD COMPOSITION AND COMPENSATION

The company's board is responsible for appointing the company'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 company generally include the CEO, the chief financial officer (CFO) and the chief accounting officer (CAO), among others.

Board structure

US companies almost invariably have a unitary board structure (that is, one single board comprising both executive and non-executive directors and that is responsible for all aspects of the company's activities as opposed to a dual board system that consists of a supervisory board and an executive board of management). Under most US state corporation statutes, directors are elected for a term of one year (*§§ 211(b); 141(d), Delaware General Corporation Law*).

State laws commonly provide the option to institute a staggered or classified board, under which directors are divided into separate classes (typically three classes), with one class being elected annually to serve a three-year term. However, classified boards have declined in popularity over the past few years due to shareholder activism, with only 27 of the top 100 US companies having staggered or classified boards in 2008, as compared with over one-half in 2004 (*see box "Top 100 US companies"*).

Shareholder groups

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 companies 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 Institutional Shareholder Services and Glass, Lewis & Co, LLC, which recommend how shareholders should vote on matters proposed to shareholders in company's proxy statements.

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 companies 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 companies in discussions of their perspectives on matters affecting the company, such as capital structure, use of capital, strategic investments and acquisitions.

Directors are generally either employees who are members of the senior management of the company or independent non-employees. However, some boards have non-executive directors who are not strictly independent (such as former senior executives of the company).

There are no state or federal law requirements to have a specific board composition, however the NYSE and NASDAQ require the board to consist of a majority of independent directors, subject to certain limited exceptions (*see box "Independent directors"*).

CEO and chairman. There are no restrictions on combining the roles of CEO and chairman, and it is not unusual for one individual to serve as both, especially in larger companies. However, shareholder activists often tend to support the separation of these roles as a corporate governance best practice, and separation has become more frequent in recent years, particularly in smaller companies.

In 2008, the roles of chairman and CEO were separated at 28 of the top 100 US companies, a significant increase from 14 in 2003. However, only eight of those 28 companies have adopted an explicit policy of splitting the two roles. In addition, 21 of the top 100 US companies specifically state that the offices of CEO and chairman of the board should not be separated.

Board size. Most states do not require a minimum number of directors and leave the size of the board to be set by the company's certificate of incorporation or by-laws. The company'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 by-laws or by a board resolution.

Age limits. There is no age limit imposed on directors, unless it is provided by the company's certificate of incorporation, by-laws or corporate governance guidelines. However, 85% of the top 100 US

companies have a mandatory retirement age (usually 72) for their non-employees directors. Common practice is for directors who are executives to retire from the board when they retire from employment with the company.

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 company is incorporated.

Nomination, election and removal of directors

Directors are generally nominated by the board, but shareholders can also suggest nominees for director in certain circumstances. Directors are elected by shareholders at the annual shareholder's meeting.

NYSE-listed companies are required to have a formal nominating or governance committee, which identifies individuals qualified to become board members and recommends their nomination to the board (*303A.04(b)(1), NYSE Listing Manual*). The committee must comprise independent directors only, unless the company in question is taking advantage of an exception to the rules available to controlled companies (that is, a company of which more than 50% of the voting power is held by an individual, a group or another company).

NASDAQ nominating has a similar requirement that nominations be made by independent directors, but does not require a formal nominating committee.

Election (or proxy) contests. Shareholders can suggest nominees for director (shareholder nominees) by following the submission procedures set out in the company's proxy statement (that is, the information statement that the company provides to its shareholders before the annual shareholders' meeting as required by the Exchange Act) (*Rule 14a-8, Exchange Act*).

Top 100 US companies

References to the top 100 US companies are to the companies surveyed in Shearman & Sterling LLP's 2008 Trends in Corporate Governance of the Largest US Public Companies survey, available at *www.shearman.com/corp_gov_publications*.

With a few 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, for the most recently ended fiscal year as published in 2008) that have equity securities listed on the New York Stock Exchange or NASDAQ.

Activist shareholders can submit their own shareholder nominees to a shareholder vote in opposition to directors nominated by the board in what is referred to as an election (or proxy) contest. Currently, shareholders are allowed to conduct an election contest under the federal securities law proxy rules and can recommend to other shareholders one or more director candidates.

However, this process is cumbersome and costly as the nominating shareholders must provide proxy materials to other shareholders at their own expense. There has been much debate over the past several years as to the circumstances, if any, under which shareholders would be permitted to nominate directors using the company's proxy materials.

The SEC is proposing an amendment to Rule 14a-8 of the Exchange Act that would enable shareholders to include in company proxy materials their proposals for by-law amendments regarding the procedures for nominating candidates to the board. The revisions to the rule would permit a shareholder who makes full disclosure in connection with a by-law proposal for director nomination procedures (for instance, a shareholder proposal seeking to amend the company's by-laws to establish a procedure under which the company would be required, in specified circumstances, to include shareholder nominees in the company's proxy materials) to have that proposal included in the company's proxy materials (*Release No. 34-56160*).

The SEC recently reaffirmed its longstanding interpretation that permits the exclusion from the company's proxy materials of a shareholder proposal that would result in an immediate election contest (that is, by making or opposing a director nomination for a particular meeting) or would set up a process for shareholders to conduct an election contest in the future by requiring the company to include shareholder nominees in the company's proxy materials for subsequent meetings (*Release No. 34-56914*).

In addition, the SEC adopted amendments to the proxy rules to facilitate online electronic shareholder discussion forums by clarifying that participation in an electronic shareholder forum is exempt from most of the proxy rules if all of the conditions to the exemption are satisfied. The amendments also state that a shareholder, company or third party acting on behalf of a shareholder or company that establishes, maintains or operates an electronic shareholder forum will not be liable under the federal securities laws for any statement or information provided by another person participating in the forum (*Release No. 34-57172*).

Voting. Directors are elected by shareholders at the annual shareholders' meeting. State corporate laws generally provide that directors are elected by a plurality vote, in which a director nominee who receives the highest number of votes cast for an open director's seat is elected to that position. Shareholders in an election under a plurality voting standard have two

Independent directors

The New York Stock Exchange (NYSE) requires that the board consist of a majority of independent directors, subject to certain limited exceptions.

A director is not independent if any of the following apply (*303A.02; NYSE Listing Manual*):

- The director has a material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organisation that has a relationship with the company).
- The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer of the listed company.
- The director or an immediate family member received during any 12-month period within the last three years, more than $100,000 in direct remuneration from the listed company (with limited exceptions).
- The director or an immediate family member has a material connection with the company's internal or external auditor.
- The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.
- The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, is more than the greater of $1 million, or 2% of the other company's consolidated gross revenues.

NASDAQ has similar requirements, however, a director can be independent under the NASDAQ Marketplace Rules even if a relationship between the director and the company exists, as long as it would not interfere with the exercise of the director's independent judgment (*4200(a)(15); IM-4200, NASDAQ Marketplace Rules*).

There are no requirements to have a specific number of independent directors under state or federal securities laws. However, US public companies are required to disclose the names of directors who are independent.

52 of the top 100 US companies have adopted policies requiring more than a simple majority of independent directors. 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 the top 100 US companies and CFOs and COOs were members of the board at seven and nine, respectively, of the top 100 US companies.

Identification. The NYSE requires companies to identify their independent directors and to disclose the basis for that determination (*303A.02(a), NYSE Listing Manual*). NASDAQ also requires identification of independent directors, but does not provide for disclosure of the basis of that determination (*4350, NASDAQ Marketplace Rules*).

Executive sessions. Both the NYSE and NASDAQ require that independent directors have regularly scheduled meetings (executive sessions) at which only independent directors are present.

Some companies set a minimum number of executive sessions. Of the top 100 US companies, 25 include an executive session of independent directors as part of every regularly scheduled board meeting.

voting choices for the election of directors: "for" or "withhold". Under the plurality voting standard, the only votes that count are "for" votes and "withhold" votes have no effect. This means that a director could be elected by a single "for" vote.

However, there has been a significant movement towards adoption of a majority voting standard for election of directors in the past several years. Under a majority voting standard, directors must be approved by more than 50% of the votes cast or by 50% of the total potential votes, whether or not actually voted, depending on what the company's corporate documents provide for. This means that a director will be elected only if he receives more than 50% of the votes cast. If a candidate receives less than 50% of the votes cast, no one is elected and a fresh election must be held.

Of the top 100 US companies, 71 now require directors to be elected by a majority of the votes cast (a big rise since 2006, when only 11 had adopted a majority voting standard). Of those 71 top 100 US companies, the vast majority require incumbent directors to submit their resignation from the board following their failure to receive a majority of the votes cast in favour of their election.

In addition, 15 of the remaining 29 top 100 US companies that continue to elect directors by a plurality of the votes cast have adopted a policy that nominees receiving more withheld votes than votes in

favour of their election must submit or tender their resignation from the board.

Broker non-votes. Brokers who hold shares of their customers registered in the brokers' name on behalf of the beneficial owner, hold shares in "street name". Brokers who hold shares in street name and who do not receive voting instructions from the shares' beneficial owners at least ten days before a scheduled shareholders' meeting can vote such shares in routine matters (*Rule 452, NYSE Listing Manual*). Controversially, routine matters currently include uncontested director elections.

In practice, because brokers often use such discretionary voting power to vote in favour of management proposals, this rule can have the effect of providing additional support for management proposals, including uncontested director elections. Depending on the number of shareholders who fail to provide their brokers with instructions on how to vote their shares, broker votes can have a deciding effect on certain proposals. In fact, some nominees at companies that have adopted a majority voting standard would be unable to obtain the required majority of votes without the broker votes.

In 2006, the NYSE proposed an amendment that would limit brokers' authority to vote shares for which they had not received any voting instructions by expressly excluding director elections from matters deemed to be "routine" for purposes of discretionary broker voting. The SEC, however, has not yet acted on the NYSE's proposal.

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

While 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. 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.

Removal. State law and the company's certificate of incorporation and by-laws set out the methods for removal of directors from the board. Generally, directors can be removed by the company's shareholders or by judicial proceedings. Most modern statutes provide that shareholders can, 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. Modern statutes also generally provide that a court can order a director to be removed, but only for cause. For instance, a court can order a director removed as the result of a proceeding commenced either by the company or by a 10% shareholder, if the court finds both that:

- The director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion.
- Removal is in the best interest of the corporation (*§ 8.09, MBCA*).

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 by-laws may also permit shareholders to fill vacancies.

Directors' compensation

Generally, unless otherwise restricted by the company's certificate of incorporation or by-laws, the board can set the directors' compensation, subject to its directors' common law fiduciary duties (*see "Duties and liabilities" below*). Listed companies must have a compensation committee composed entirely of independent directors. The compensation committee must have a written charter that addresses the committee's purpose and obligations, as well as the annual performance evaluation of the committee. Compensation may include cash, the company's shares or options on the shares.

The NYSE and NASDAQ both require shareholder approval of equity compensation plans covering directors (*303A.08, NYSE Listing Manual; 4350(i)(1)(A), NASDAQ Marketplace Rules*). No approval is required for cash compensation paid to directors.

In recent years, shareholder activists have pressed companies to adopt certain compensation-related measures, including:

- A policy allowing shareholders to annually pass a non-binding advisory resolution that ratifies the compensation for certain named executive officers disclosed in the proxy statement.
- A limit on total compensation for the CEO and other named executive officers.
- A pay-for-performance policy under which all or a significant portion of future equity and incentive awards granted to employees be performance-based.
- The limitation of certain benefits, tax gross-ups and acceleration of equity awards on a termination of employment or change in control.

Disclosure. Directors of public companies are required to disclose their compensation in a proxy statement or annual report filed by the company with the SEC (*Releases No. 33-8732A; 34-54302A; Item 402, Regulation S-K*).

In addition, a company must include a "Compensation Discussion and Analysis" (that is, a statement from the company and its management on its policies and decisions on executive compensation) in its documents that are periodically publicly filed with the SEC.

Directors are not required by law to own shares in the company of which they are a

director. However, the company's certificate of incorporation, by-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 company's other shareholders.

If a director owns publicly-traded shares in a company of which he is director, he must (*§ 16, Exchange 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.

MANAGEMENT RULES AND AUTHORITY

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

Under Delaware law, unless the certificate of incorporation and by-laws provide otherwise, 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. The directors can also take valid actions without a meeting (that is, by written consent), unless the certificate of incorporation or by-laws provide otherwise.

Directors' powers

State law and the company's certificate of incorporation typically provide that the board can exercise all of the company's powers, but the board's powers can be restricted by the company's certificate of incorporation or by-laws and may be subject to state law limitations. In addition, certain actions and transactions require shareholder approval, such as mergers and amendments to the certificate of incorporation.

State law and a company'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, state law often restricts the scope of the activities that can be conducted by a committee of less than the entire board.

Committees. 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 by-laws) other than the power to (*§ 141, Delaware General Corporation Law*):

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

No particular committee structure is designated by state law, however, federal securities laws require public companies to have an audit committee composed entirely of independent directors (*§ 10A(m)(3), Exchange Act*).

The audit committee is responsible for the appointment, compensation and oversight of the independent public accounting firm employed to audit the company's financial statements.

The NYSE and NASDAQ also require that listed companies have an audit committee (*303A.06, NYSE Listing Manual; 4350(d), NASDAQ Marketplace Rules*).

In addition to an audit committee, the NYSE requires its listed companies to have a nominating or corporate governance committee and a compensation committee (*303A.04; 303A.05, NYSE Listing Manual*).

NASDAQ does not require such committees, but does require that compensation and nominating actions be made solely by the independent members of the board. In practice, most companies that have their securities listed on NASDAQ have such committees. Subject to certain exceptions, all of these committees must consist of independent directors only.

DUTIES AND LIABILITIES

Directors owe the company and its shareholders the following duties:

- 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 company's best interest, and not on any personal interest.

In determining whether a director has satisfied his fiduciary duties, the courts generally apply the "business judgment 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 company or in conflict of interest situations.

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

Directors can be held personally liable under certain circumstances, including:

- Theft and fraud. A director can be criminally liable under both federal and state laws for theft and fraud. Directors can also be held liable under other federal statutory schemes.

- Breach of securities law. Directors of public companies can be held both civilly and criminally liable for violation of state and federal securities laws in a number of circumstances. For example, directors cannot trade in a company's securities when in possession of material, non-public information (*Rule 10b-5, Exchange Act*). Federal securities law also imposes liability on directors for intentional or reckless misrepresentations or material omissions made in securities offering documents or proxy statements (*see box "Directors' liability for public statements"*).

- Insolvency. In recent years many courts and commentators have considered whether the directors of a company that is insolvent, or may possibly become insolvent, owe fiduciary duties to the company's creditors.

  The Delaware Supreme Court recently held that where a company is in the "zone of insolvency" or clearly insolvent, the directors have a fiduciary duty to exercise their business judgment in the best interests of the company, and creditors cannot bring direct claims against the directors for breach of fiduciary duty (*North American Catholic Education Programming, Inc v Gheewalla, 930 A.2d (Del 18 May, 2007)*).

  Creditors of an insolvent Delaware company have standing to maintain derivative claims against directors on behalf of the company for breaches of fiduciary duties but have no right to assert direct claims for breach of fiduciary duty against corporate directors. 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.

- Corrupt payments. Directors can be criminally and civilly liable for knowing violation of the Foreign Corrupt Practices Act of 1977, which targets corrupt payments made to foreign officials and prohibits a company from indemnifying its directors and officers for fines (*see Article, "The Foreign Corrupt Practices Act: US legislation with global implications", page 167*).

Directors' liability for public statements

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 company's accounts (*§§ 11 and 12, Securities Act; Rule 14c-6, Exchange Act*).

In the context of securities offerings, every director of the company 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 in the registration statement or necessary to make the statements in the registration statement not misleading (*§ 11, Securities Act*).

Similarly, every director of the company 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 in the prospectus or necessary to make the statements in the prospectus not misleading (*§ 12, Securities Act*).

A director can avoid liability by proving that he had acted in good faith and without knowledge.

Under the Sarbanes-Oxley Act of 2002, 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), Exchange Act*).

Limitations on liability

Most states allow a company to limit directors' personal liability to the company or its shareholders for breach of their fiduciary duties subject to certain restrictions. 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.

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

Public companies typically obtain insurance on behalf directors to cover any error, misstatement, misleading statement, act, omission, neglect or breach of duty.

One of the most serious concerns for officers and directors are the legal fees associated with frivolous claims, and such insurance typically covers the legal fees from a criminal proceeding or any formal civil administrative or regulatory pro-

ceeding. However, insurance cannot protect directors against liability based on the director's fraud, dishonesty or violations of criminal law.

Indemnification

State law also provides that a company indemnify the directors in certain circumstances. Under Delaware law, any person made a party to proceedings for being the company's director is entitled to indemnification by the company against losses the director incurs by virtue of his corporation duties, provided that the director both:

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

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

Transactions and conflicts

The duty of loyalty requires a director to act in the best interests of the company and not for personal profit or gain or for other advantages which do not benefit the company.

A director can be held liable to the company if he allows an actual or potential conflict between his personal interests and the best interests of the company 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 company, the director owes a duty to the company not to use that opportunity or knowledge for his own benefit.

Transactions between a director and the company are voidable under common law, but many states have safe harbor statutes (for example, § 144(a) of the Delaware General Corporation Law) that generally provide that a transaction is not voidable if either of the following apply:

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

Accordingly, it is best to have such transactions approved in advance by the disinterested directors or the shareholders.

In addition, there are restrictions on certain transactions between a company and its directors. For example, directors are prohibited from receiving personal loans or extensions of credit from the company, with limited exceptions (*§ 402, Sarbanes-Oxley Act of 2002* (Sarbanes-Oxley)).

Under the NYSE Listing Manual, a director does not qualify as independent unless the board affirmatively determines that the director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organisation that has a relationship with the company) (*303A.02(a), NYSE Listing Manual*).

Dealings in securities. Generally, there are no restrictions on the purchase or sale of a company's securities by a director, other than:

- Restrictions in relation to insider trading. A director cannot trade in company shares if he possesses material non-public information about the company. In addition, companies usually have policies which regulate trading by officers and directors.
- Restrictions on trading during certain black-out periods tied to the company's pension fund.
- Restrictions on public resale of restricted and control securities (*Rule 144, Securities Act*). Such resale is permitted only if certain conditions are met, including in certain circumstances:
  - a holding period requirement;
  - a current public information requirement;
  - a volume limitation;
  - a manner of sale condition;
  - a brokers transaction requirement; and
  - the notice of proposed sale filed with the SEC on Form 144.

Disclosures. 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, Exchange Act*). In addition, when a director acquires more than 5% of the company's shares, certain additional disclosures must be made (*§§ 13(d) and (g), Exchange Act*).

Federal securities laws require disclosure concerning transactions with the company. Companies must disclose material transactions that exceed $120,000 and in which certain related parties had a direct or indirect material interest (*Item 404, Regulation S-K*). Such related parties include the following:

- Officers.
- Directors.
- Director nominees.
- Beneficial owners of 5% or more of the company's common stock.
- Immediate family members of any of the above.

In addition, companies must disclose the policies and procedures used in reviewing and approving such related party transactions. In 2008, 70 of the top 100 US companies disclosed transactions in which the company was a participant and in which a related person had a direct or indirect material interest.

SHAREHOLDER RELATIONS

State law generally requires companies to hold an annual shareholders' meeting. Under Delaware law for example, unless directors are elected by written consent in lieu of an annual meeting, an annual shareholders' meeting 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 by-laws, and if not so designated, as determined by the board. Most companies' 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.

Companies are required to provide information to shareholders before the annual shareholders' meeting in the form of a proxy statement (*Rule 14a-3, Exchange Act*).

Proxy statements typically solicit shareholder votes on the election of directors, ratification of the company's independent accountants, and often, on the approval of stock option plans related to executive compensation. A proxy statement may also include shareholder proposals put forth by shareholder activists.

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

Minority shareholder action

If a minority shareholder believes the company is being mismanaged it can:

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

Company reporting

Companies subject to the Exchange Act reporting obligations must file:

- Annual reports on Form 10-K after the end of the fiscal year covered by the report. The filing deadline is 60, 75 or 90 days after the end of the fiscal year, depending on the nature of the company.
- Quarterly reports on Form 10-Q after the end of the quarter covered by the report. The filing deadline is 40 or 45 days after the end of the quarter, depending on the nature of the company.
- Current reports on Form 8-K after four days of the occurrence of certain events related to the company's business and operations, financial information, securities and trading markets, accountants and financial statements, corporate governance and management and asset-backed securities.

Companies that are foreign private issuers and are subject to the Exchange Act reporting obligations must file:

- An annual report on Form 20-F within six months after the end of the fiscal year covered by the report.
- Periodic reports on Form 6-K relating to certain information that is material to the foreign private issuer promptly after such information is made or required to be made public pursuant to local laws, is filed or required to be filed with a stock exchange on which its securities are traded and which was made public by that exchange, or is distributed or is required to be distributed to its security holders.

Internal controls, accounts and audit. The rules adopted by the SEC under Section 404 of Sarbanes-Oxley impose formal requirements relating to the company's internal control over financial reporting (which is a part of the company's internal controls). For every public company, 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 company's internal control over financial reporting.
- Containing an assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the internal control structure and procedures of the company for financial reporting.

In addition, the company's independent auditor is required to issue an attestation report on the company'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.

Independent auditor. The annual financial statements of companies must be audited by a registered independent an accounting firm. Interim financial state-

ments are not required to be audited but are required to be formally reviewed under applicable accounting literature.

The auditors must be independent under the federal securities laws and the rules of the Public Company Accounting Oversight Board (PCAOB). Auditors of public companies 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 company, was employed by that registered public accounting firm and participated in any capacity in the audit of the company during the one-year period before the initiation of the audit.

The company's audit committee is responsible for hiring an independent registered public accounting firm as its auditor, if the company is public. The auditor must then be approved by the entire board and the retention of the firm is often put before the shareholders for ratification. The accounting firm must rotate the lead accounting firm partner responsible for coordinating and reviewing the company's audit every five years (*§ 203, Sarbanes-Oxley*).

There are also restrictions on services that auditors can perform for the companies for which they audit accounts (*§ 10A(g), Exchange Act*). 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, 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 company's audit committee.

Auditor liability. Auditors are potentially liable to the company, shareholders and third parties if the audited accounts are inaccurate.

Generally auditors cannot limit their liability to their audit clients because such limitations are viewed as impeding their independence. It may, however, be possible for auditors to limit, in their engagement letter, the punitive damages an audit client can claim.

Auditors can be liable for negligent misrepresentation to third parties 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 in the audit/internal control opinion (*§ 10A(d), Exchange Act*).
- In the context of a securities offering by a company based on the financial statements and attestation to the company's internal controls included in the company's registration statement (*§ 11(a), Securities Act*).

Whistleblowing. Audit committees must establish procedures to enable employees to confidentially and anonymously submit concerns they might have in relation to the company's accounting, internal controls or auditing matters (*§ 10A(m)(4), Exchange 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.

Corporate social responsibility

Companies often highlight their achievements related to social and ethical responsibilities in their annual report. These disclosures are driven more by best practice rather than legal requirements. There are more extensive disclosure requirements relating to environmental matters. A company must also disclose certain shareholder proposals, legal proceedings and other material corporate matters, which can include items relating to social responsibility.

In recent years, shareholders, governments and non-governmental organisations have applied increasing pressure on companies to devote more of their resources to issues related to corporate social responsibility. In response to this pressure, 33 of the top 100 US companies have established a public policy committee.

Stephen Giove is a partner and Fabiana Sakai, Matthew Musselman and Dorman Tong are associates at Shearman & Sterling LLP.

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