

# the Corporate Governance I a d v i s o r

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## SHAREHOLDER ACCESS

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### The SEC'S Director Nomination Initiative: Is It the Next "Jaws" Sequel?

by *Henry Lesser and David Leeb*

*"Just when you thought it was safe to go back  
into the water . . ."*

*(tagline for the 1978 movie "Jaws 2")*

*"This summer it's finally safe to go back in  
the water . . ."*

*(tagline for the 1996 movie "Flipper")*

The Sarbanes-Oxley Act (SOA) of 2002 is the law of the land, the Security and Exchange Commission's (SEC's) massive rulemaking package under it is completed, our corporate governance version of a tectonic shift is settling down to a series of minor aftershocks, and corporate America is getting used to living with the new paradigms. So it's time for directors to refocus on to the business of overseeing the business, which is their primary job. Right?

Maybe not! The SEC is now engaged in a rulemaking process that, some commentators believe, will make a more dramatic change in the governance landscape than the entirety of the SOA changes combined, a veritable

*Continued on page 2*

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## Editor's Note

Thanks to Editor Emeritus Henry Lesser, we present this special "shareholder access" issue at a very timely moment in corporate governance history.

The SEC is in the midst of a major overhaul of its rules regarding the board nomination process. On August 6, 2003, the SEC, as the first phase of this project, issued proposed rules that would require companies to provide more disclosure about nominating committee activities and how shareholders can communicate with directors. This issue features an article describing those proposals and the background to the SEC initiative. As we go to press, those proposals are still pending.

On October 8, 2003, the SEC, as the second phase of its project, issued proposed rules to facilitate the ability of shareholders to nominate directors through the corporate proxy machinery. This proposal promises to be more controversial at any single rule making adopted under the Sarbanes-Oxley Act. The SEC proposed these rules after our deadline to get this issue to you, but our next issue will analyze this important proposal in detail.

To help our readers understand the significance of the SEC's two-part initiative in the context of corporate governance practices outside the United States, this issue contains articles explaining the shareholder nomination laws (or lack thereof in many cases) of eight different countries. Because of the significance of this topic, in future issues, we also plan to run articles on how it is addressed in countries not covered in this roundup.

**Broc Romanek, Editor-in-Chief, *Corporate Governance Advisor***

## SEC's Director Nomination

*Continued from page 1*

Krakatoa of reform. This time around, without any legislative directive forcing its hand, the SEC is considering a major shake-up in the way that public companies nominate board candidates and explain their nomination processes.

What the SEC has in mind is not only requiring significantly more detailed proxy statement disclosure regarding how nominating committees deal with shareholder nominees and how shareholders can communicate generally with the board—the subject of an existing rule proposal—but also an access right to force companies to include shareholder nominees in their own proxy materials without recourse to a proxy fight involving dueling proxy statements, proxy cards, and fight letters. This access right does not currently exist under the proxy rules, state corporate law, or exchange listing requirements.

There is every indication that, if the SEC proposes an access rule, it will contain limits designed to ensure that not every annual shareholders' meeting turn into a corporate version of the 2003 California gubernatorial recall campaign. It seems likely that the proposal will be limited to "short slates" (*i.e.*, a minority of the board seats to be filled), cap the number of alternative candi-

dates, limit the number of eligible shareholders through minimum ownership requirements, and confer a nomination right only after specified kinds of triggering events have occurred. The SEC even may decline to impose a substantive nomination right and, instead, amend the current shareholder proposal rule to permit proposals that call on companies to create a nomination right themselves.

Nevertheless, the basic idea of an access right, which the SEC launched in spring 2003,<sup>1</sup> has already engendered a fierce debate between two schools of thought.

Arrayed on one side are the critics who contend that any rule that allows shareholders to force their own candidates onto the company's proxy statement and proxy card will create a disruptive shift in the balance of corporate power that is antithetical to good governance by creating voting confusion among the "electorate," disincentives to qualified directors who agree to be nominated as company candidates, and polarized board factions. According to this side of the debate, the proposal is too much too soon, and we should first wait to see whether the recent governance crises and the legislative/regulatory responses (specifically SOA), together with enhanced self-policing by directors, restore trust in a better-functioning system.

Lined up on the other side are the commentators who assert that a key lesson from the cluster of governance

failings that propelled SOA into law (Enron, WorldCom,<sup>2</sup> Global Crossing, Tyco, and the other poster children for board oversight failures) is that shareholders need a louder voice in the process of selecting board candidates, full director accountability demands an alternative to a system in which boards select their own candidates, and the expense and contentiousness of formal election contests makes them an ineffective non-shareholder-friendly alternative.

Those readers who are interested in highly articulate statements of both positions can do no better than read the forthcoming issue of *The Business Lawyer*, the journal of the ABA's Business Law Section. There you will find a forceful argument against the access concept from Martin Lipton and Steven Rosenblum of Wachtell, Lipton, Rosen & Katz;<sup>3</sup> a rebuttal of that argument from Professor Lucian Bebchuk of Harvard Law School;<sup>4</sup> and an institutional investor perspective generally supportive of some access right from Robert C. Pozen, a visiting professor at Harvard Law School.<sup>5</sup>

These articles (and numerous comments that the SEC has received already<sup>6</sup>) are hardly the last words in the debate. After all, the SEC has not issued a formal access proposal yet and, while it is expected to do so in the near future, its pronouncements to date clearly recognize both the controversial nature of the fundamental concept (which it has declined to propose in three separate evaluations of the nomination process over the past 60 years<sup>7</sup>) and as the myriad detailed issues that any proposal will have to address under both the proxy rules and related provisions of the securities laws (such as the Schedule 13D beneficial ownership reporting requirements and the Section 16 short-swing profit provisions). Moreover, whatever shape a formal rule proposal takes, the possibility of a jurisdictional challenge to the SEC's authority in an area hitherto regulated at the state level cannot be discounted.

Much, therefore, remains to be written on this SEC initiative. Meanwhile, the balance of this article will focus on the two sets of proposals that the SEC actually issued in August 2003.<sup>8</sup> Future developments, both regarding the finalization of those proposals and on the access front, will be addressed in subsequent issues of this publication.

## Proposed Nominating Committee Rules

### The Proposal Described

The proposal would expand current disclosure regarding a company's nominating committee (or other board committee performing a similar role)<sup>9</sup> by requiring companies to include the following in their proxy statements:

- If the company does not have a standing nominating committee, a statement of the specific basis for the board's view that it is appropriate not to have one and the names of those directors who participate in the consideration of director nominees;
- If the nominating committee has a charter, a description of its material terms and where it is available (which can be the company's Web site) or, if the committee does not have a charter, a statement of that fact;

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- If the company's securities are listed, any instance during the last fiscal year when any member of the nominating committee did not satisfy the definition of independence in the applicable listing standards;
- If the company's securities are not listed, whether each member of the nominating committee is independent, identifying which definition of independence from a national securities exchange or a national securities association it used (which would have to be applied to all committee members);
- If the nominating committee has a policy with regard to the consideration of any director candidates recommended by security holders, a description of its material elements, including a statement as to whether the committee will consider director candidates recommended by security holders, or if the committee does not have such a policy, a statement of that fact;
- A description of any specific, minimum qualifications that the nominating committee believes must be met by a nominating committee-recommended nominee for a board position, any specific qualities or skills that the committee believes are necessary for one or more of the company's directors to possess, and any specific standards for the overall structure and composition of the board;
- A description of the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether or not the nominee is recommended by a security holder;
- A statement of the specific source, such as the name of an executive officer, director, or other individual, of each nominee (other than nominees who are executive officers or directors standing for re-election) approved by the nominating committee for inclusion on the company's proxy card;
- If the company pays a fee to any third party or parties to identify or assist in identifying or evaluating potential nominees, disclosure of the function performed by each such third party; and
- If the nominating committee (a) receives a recommended nominee from a security holder or group of security holders who individually, or in the aggregate,

beneficially owned greater than 3 percent of the company's voting common stock for at least one year as of the date of the recommendation and (b) the nominating committee decides not to nominate that candidate,

- The name or names of the security holders who recommended the candidate (but not the candidate's identity), and
- The specific reasons for the nominating committee's determination not to include the candidate as a nominee.

### The Proposal Evaluated

In a clear effort to differentiate its disclosure proposal from any subsequent access proposal that it may issue, the SEC has stated: "These proposed disclosure requirements would not mandate any particular action by a company or its board of directors; rather, the proposals are intended to make more transparent to security holders the operation of the boards of directors of the companies in which they invest."<sup>10</sup> In other words: However strongly some might object to what we have in mind next, how can anyone reasonably quarrel with simply telling shareholders how the nominating process actually functions at each public company?

The comment period for the proposed rules ended on September 15, 2003, and while commenters expressed little vehement objection to the underlying concept of transparency, reactions ranged from enthusiastic support to critiques of the timing and specific aspects of the rules.<sup>11</sup> It is telling, however, that both in formal comment letters and in informal comments directly addressing the disclosure requirements, some commentators have anticipatorily addressed strong views (either pro or con) on the issue of shareholder access, which appears to be where the real battle will be fought.<sup>12</sup>

Before the corporate community rushes to embrace this dichotomy between *describing* "what is" and *prescribing* "what should be," each individual company needs to understand that a requirement to disclose how it nominates directors—and, in particular, how it deals with shareholder nominees—may very well require it to change its nomination procedures in order to avoid the effect of disclosure that would not be well received by the institutional investor community. Perhaps the change will be salutary; some would even argue over-

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due. The point, however, is that in many cases, significant change *will* be the effect of these requirements, whether or not intended by the SEC. How many companies, for example, will be willing to disclose that their nominating committees do *not* have formal charters, policies for considering shareholder nominees, or minimum qualifications for their own nominees?<sup>13</sup>

Moreover, the distinction between *description* and *prescription* is particularly blurred by the proposal for disclosure regarding the rejection of a nominee submitted by a 3-percent shareholder. While the SEC has not yet proposed an access right, it is not hard to imagine the encouragement that investors with significant holdings will receive for their claimed right to compel companies to give serious consideration to their nominees if companies are forced to disclose specific reasons why these investor nominees were rejected.

## Proposed Rules Relating to Communications with Boards of Directors

### The Proposal Described

The proposal would also expand current disclosure<sup>14</sup> by requiring companies to include in their proxy statements:

- A statement as to whether the board provides a process for security holders to send communications to it and, if not, the specific basis for the board's view that it is appropriate not to have one; and
- If the company has such a process:
  - A description of the manner in which security holders can send such communications to the board;
  - Identification of those board members to whom security holders can send communications;
  - If all security holder communications are not sent directly to board members, a description of the company's process for determining which communications will be relayed to board members, including disclosure of the department or other group within the company that is responsible for making this determination; and
  - A description of any material action taken by the board during the preceding fiscal year as a result of communications from security holders.

### The Proposal Evaluated

In the SEC's view,<sup>15</sup> a disclosure requirement regarding whether a board has a process by which security holders can communicate with it is necessary to give them a better picture of a critical component of the board's interaction with them and, without the specificity of this proposal, disclosure could be at a level of generality that may not be sufficiently helpful to them in understanding and evaluating the process.

As with the nominating committee disclosure proposal, the issue with this proposal is whether the requirement for *description* will become *de facto prescription*. How many companies, for example, will be willing to disclose that they do *not* have a shareholder communication process? And how many of them will want communications to go to individual directors rather than establish a formal channel between the communicating shareholder and the entire board?

Moreover, it is not hard to imagine the encouragement that activist shareholders will receive in their claimed right to compel companies to give serious consideration to their suggestions, which might or might not otherwise find their way into non-excludable shareholder proposals under Rule 14a-8 or become platforms for formal proxy contests, from the requirement of disclosure of material action taken by the company as a result of those suggestions (and by necessary implementation from non-disclosure of any such action, an arguable failure to take their suggestions seriously).

### Conclusion

A great deal about the SEC's nomination initiative is still up in the air. Will the final disclosure requirements look a lot like the amended proposals, or will they be significantly revised in response to comments? Will the SEC proceed with an access proposal, and if so, what will it look like? Will this initiative result in a dramatic paradigm shift, with positive or negative impact on corporate performance, or turn out to be ho-hum?

Whatever the ultimate answer, our expectation is that the disclosure proposals, if adopted in anything close to their proposed form, will result in change, in some cases substantial, in how companies handle their nomination and shareholder communication processes and some increase in the influence of shareholders not only on board composition but also on a broad array of corporate

decisions. Whether that makes these proposals the next “Jaws” sequel or just another “Flipper” movie remains to be seen.

## Notes

1. On April 14, 2003, the SEC announced that it had directed its Division of Corporation Finance to review and formulate possible changes to the proxy rules and interpretations regarding the election of directors. Press Release No. 2003-46. On May 1, 2003, the SEC solicited public views as to the Division’s review. Press Release No. 2003-59, Release No. 34-47778, File No. S7-10-03. On July 15, 2003, the Division issued Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors (Staff Report), available at [www.sec.gov/news/studies/proxyreport.pdf](http://www.sec.gov/news/studies/proxyreport.pdf).

2. In August 2003, Richard C. Breeden (a former SEC Chairman), as the court-appointed Corporate Monitor in the WorldCom/MCI bankruptcy proceedings, issued “Restoring Trust,” a report containing 78 recommendations relating to WorldCom/MCI’s governance. Recommendation 1.13, relating to the nomination of directors, would require WorldCom/MCI’s governance committee to organize a committee comprised of representatives of the 10 largest shareholders representing at least 15 percent of the outstanding shares that would propose board nominees and, if unable to reach agreement with the governance committee, would be entitled to designate one nominee for each vacancy. For a forceful critique of this proposal, see Wachtell, Lipton, Rosen & Katz client memorandum, “‘Restoring Trust’ or Losing Perspective” (Aug. 27, 2003).

3. See Lipton and Rosenbloom, “Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come,” *The Business Lawyer*, \_\_\_\_\_ (2003).

4. See Bebchuk, “Shareholder Access to the Ballot,” *The Business Lawyer*, \_\_\_\_\_ (2003), also available as Discussion Paper No. 428 (08/2003) of the John M. Olin Center’s Program on Corporate Governance, Harvard Law School.

5. See Pozen, “Institutional Perspective on Shareholder Nominations of Corporate Directors,” *The Business Lawyer*, \_\_\_\_\_ (2003), also available as Discussion Paper No. 429 (08/2003) of the John M. Olin Center’s Program on Corporate Governance, Harvard Law School. The author, who was Vice Chairman of Fidelity Investments until 2001, focuses principally on the five alternatives put forward for SEC consideration in the ABA Task Force comment letter to Staff Report (*infra* n.6) but also argues for mandatory cumulative voting in director elections, while noting that this would require changes in state corporate law rather than federal securities regulation.

6. In response to its May 1, 2003, solicitation of public comment (*supra*, n.1), the SEC received hundreds of comments, which it summarized in Appendix A to the Staff Report (*id*). The ABA comment letter used as a reference point in the Pozen article (*supra* n.5) was submitted on June 13, 2003, by the Task Force on Shareholder Proposals of the ABA Business Law Section’s Committee on Federal Regulation of Securities. All comment letters are available at [www.sec.gov/rules/other/s71003.shtml](http://www.sec.gov/rules/other/s71003.shtml). In addition, a number of the comments the SEC received on the disclosure proposals discussed in this article anticipatorily addressed the prospect of SEC rulemaking on an access concept (see *infra* n.11).

7. The SEC’s prior reviews of this issue, in 1942, 1977, and 1992, are discussed in the Background section of Staff Report (*supra* n.1).

8. See Release Nos. 34-48301; IC-26145; File No. S7-14-03 (Aug. 8, 2003) (Proposing Release). See also Press Release 2003-92 (Aug. 6, 2003).

9. The current requirements, first adopted in 1978, are contained in Item 7(d) of Schedule 14A under the Securities Exchange Act of 1934. The registrant must: state whether it has a standing nominating committee (or committee performing similar functions); disclose, if it has such a committee, its members, the number of its meetings during the last fiscal year, its functions, whether it will consider nominees recommended by security holders, and if so, the procedures that they must follow in submitting recommendations. In Proposing Release (*supra* n.8), the SEC notes that, although the pending NYSE and NASDAQ governance proposals would require listed companies to have independent nominating committees (or, in NASDAQ’s case, have nominees determined by a majority of independent directors), see Release No. 34-47672 (April 11, 2003) and Release No. 34-47516 (March 17, 2003), they would not require nominating committees to consider shareholder nominees or companies to make the disclosures the SEC has proposed.

10. See Proposing Release, *supra* n.8 at p.1.

11. The SEC received approximately 126 comment letters from a range of constituencies, including the corporate community, individual and institutional investors, and academics. Comments received by the SEC from the corporate community tended to be more critical of specific aspects of the proposed rules, citing areas of overlap between the proposed rules, existing proxy statement disclosure requirements, and proposed Nasdaq and NYSE rules and urged the SEC to use caution and to take its time in assessing the impact of other SOA-related reforms before issuing final rules. Comments received from the investor community tended to strongly support the proposed rules (or offer suggestions on how to strengthen them), while calling for the SEC to move forward with proposed rules on shareholder access to the proxy card. All comment letters are available at <http://www.sec.gov/rules/proposed/s71403.shtml>.

12. For instance, Hank McKinell, Chairman and CEO of Pfizer Inc., in remarks to the Council of Institutional Investors at a meeting in San Diego, CA, on September 4, 2003, said, in part: “Pfizer supports these additional requirements for disclosure. Our concerns are about the next set of SEC staff recommendations, which recommend that shareholders be given wide access to the process for nominating and electing directors.” In its August 20, 2003, comment letter to the SEC, the Council of Institutional Investors wrote: “The proposed disclosure reforms are a significant first step. We look forward to the second, most important step for investors—the adoption of rules giving shareholders access to management’s proxy card to nominate potential directors.”

13. At a presentation made on September 11, 2003, at the American Society of Corporate Secretaries’ Western Regional Conference in Santa Barbara, CA, a representative of Institutional Shareholder Services (ISS), the most influential proxy advisory service, indicated that ISS would be closely reviewing the disclosures made during the 2004 proxy season in response to the final version of the SEC’s proposed rules and that those disclosures would affect ratings under ISS’ CGQ (corporate governance quotient) system.

14. As noted in Proposing Release (*supra* n.8) at p.11, the NYSE has a pending SEC-approval proposal, see Release No. 34-47672 (Apr. 11, 2003), requiring a listed company to disclose a method for interested parties to communicate directly and confidentially with the presiding non-management director or with non-management directors as a group.

15. See Proposing Release, *supra* n.8 at p.13.

## Shareholder Access in the United Kingdom

by *Richard Smerdon*

This is about how, both in theory and in practice, shareholders in the United Kingdom can attempt to engineer board change, including the ability of UK shareholders to nominate directors. While there are interesting analogies to be made between the ways in which shareholders can persuade boards to change in the United States and the United Kingdom, there are significant differences in practice, law, and culture.

First, one must understand the limited nature of the analogy between the US “proxy statement” and the UK “annual report.” In many ways, they are similar in content. However, the US proxy statement is required under the US securities laws to contain information that is intended to provide shareholders with a basis upon which they cast their votes at an annual shareholders’ meeting. In contrast, the UK annual report does not currently have that function, save in two respects relevant to this article, namely:

1. The submission of names by the board of either new directors or directors who are required to be re-elected, either because they have been appointed by the board since the last annual meeting or because they have served for a three-year period. In these cases, the board is required by the Combined Code to give biographical details of the nominees and to describe why it believes that a nominee should be appointed or re-appointed; and
2. The submission of the annual “remuneration report” to shareholders.

Nevertheless, the UK process can in theory, but not in practice, provide shareholders with powers to change the composition of boards, either at an annual meeting or at a special meeting of shareholders. However, formal nominations of director by shareholders (as being considered by the US SEC) are not known in the United Kingdom at all.

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Although there are theoretical legal powers for shareholders to remove and appoint a director, these powers are very rarely used in the United Kingdom in the context of listed companies. This is partly due to the expense and numerous procedural difficulties, but mainly due to a cultural antipathy towards that approach.<sup>1</sup> In practice, informal shareholder pressure coupled with the eventual effects of new Combined Code of governance best practices are the most likely and commonly used engines for board change.

### The UK Annual Report

Every UK listed company is required by the Companies Act 1985 to send to its shareholders an annual report. The report is required by law to contain, among other things:

- A review of the business;
- The names of the directors;
- The principal activities and changes during the year;
- Directors’ share interests;
- Political donations;
- “Important events” during the year;
- “Likely future developments”; and
- Research and development activity.

As of July 2003, the report also is required to state details of the “compensation” of directors (in the United Kingdom, the term “remuneration” is used; “compensation” means damages for breach of contract), in the form of a “Directors Remuneration Report.” That report must set forth both the company’s remuneration *policy* and the actual remuneration of directors in great detail. Then, the policy gets put to a vote at the annual meeting.

The annual report is required by the UK Listing Authority to state, among other matters, how the company has applied the main and supporting principles of a code of governance best practice called the Combined Code and whether it has complied with the provisions of the Code (and if not, why not). It should be noted that

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failure to make these statements carries no real penalty against the company or its directors, as the UK Listing Authority has the power to delist a company for this failure but never does. In practice, media attention, shareholder pressure, and it has to be said, the willingness of the great majority of companies to comply achieves compliance most of the time. These statements are contained in a lengthy governance statement in the body of the annual report.

## The Role of the Combined Code

Recently, the Combined Code was revised in a radically different form. Most of the changes relate to board structure and composition; the role of the non-executive director; the composition and roles of the audit, remuneration, and nomination committees; and financial and auditing controls. The principal parts of the new Combined Code (which takes effect for listed companies for financial years commencing November 1, 2003) that deal with boards are as follows:

- *The board's responsibility.* Main Principle A.7 states, *inter alia*, that “the board should ensure planned and progressive refreshing of the board.”
- *The nomination committee.* The new Combined Code requires that boards have a nomination committee:

There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of the members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee . . . the nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. *A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments* (author's emphasis). An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non executive director.

- *Terms of office.* Code Provision A.7.2 provides for the following:
  1. Non-executive directors should be appointed for specified terms (subject to re-election);

2. Every Director should be submitted for re-election at the first annual meeting after appointment and at not later than every three years of his/her term of office;
  3. The board should set out to shareholders in the papers accompanying a resolution to elect a non executive director why it believes an individual should be elected;
  4. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role;
  5. Any term beyond six years (*e.g.*, two three-year terms) for a non executive director should be subject to particularly rigorous review *and should take into account the need for progressive refreshing of the board* [author's emphasis]; and
  6. Directors may serve for longer than nine years (*e.g.*, three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in Combined Code Provision A.3.1).<sup>2</sup>
- *Terms of appointment.* Provision A.4.4 states: “The terms and conditions of appointment of non executive directors should be made available for inspection. The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and a board should be informed of subsequent changes.”
  - *Performance evaluations.* Main Principle A.6 (performance evaluation) states: “The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.” The corresponding Supporting Principle states: “Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance

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evaluation by recognising the strengths and addressing the weaknesses of the board *and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.*" [author's emphasis]

## **How UK Shareholders Vote on Board Nominees**

In the United Kingdom, the annual report is sent out at the same time as the annual accounts (the US equivalent is the audited financials included in the Form 10-K) and the notice convening the annual meeting. The notice convening the meeting contains resolutions that roughly follow a standard format including:

- A resolution "noting" the annual accounts;
- Separate resolutions re-electing newly appointed directors;
- Separate resolutions re-electing non-executive directors who retire by rotation or at the end of each three year period of office; and
- A resolution to approve the annual remuneration report.

The notice of meeting is sent out to shareholders 20 business days in advance of the meeting and is accompanied by a proxy card that summarizes the resolutions and has a box opposite each resolution for shareholders to decide whether they are for or against each resolution. Thus, shareholders have three choices: to vote for, against, or abstain. In practice, shareholder apathy has prevailed and most fail to vote at all. In fact, Unilever recently wrote to 10 of its largest shareholders to ask why they had not voted at their last annual meeting.

In the case of director appointment resolutions, the Combined Code requires that biographical details of each nominee be disclosed as well as reasons why the board thinks that the nominees are suitable. So, in theory, it is possible for shareholders to vote against the re-appointment of a director, but in practice this has not (in the experience of the author) ever happened. The resolutions are invariably passed.

Moreover, there is no precedent to provide for the appointment of new directors by shareholders. Just to emphasize the point, no opportunity is given for shareholders to nominate their own choice of directors, even if they vote against a particular director, and in fact in

the view of the author, there is no institutional pressure to have that power currently. Do the institutions talk to nomination committees about possible additional directors? In the author's experience, the answer is no. They may talk about the need to remove an apparently non-performing member of the board, but not the reverse.

## **Can Shareholders Remove or Appoint a Director By Themselves?**

Under § 303 of the Companies Act 1985, shareholders may remove a director and appoint another in his or her place by the use of an ordinary resolution (that is to say, a resolution that is passed by a simple majority of those present and voting in person or by proxy). It should be emphasized that this law contemplates only *removal* followed by appointment to fill a vacancy, not a simple right to appoint or nominate an additional director to the board.

Under § 303, the process is extraordinarily cumbersome, particularly when, as is invariably the case, a shareholders meeting to carry out the removal has to be requisitioned by the requisite number of shareholders (holders of 10 percent of the voting shares) against a reluctant board. The procedural hurdles and legislative ambiguity are a nightmare. Accordingly, for these reasons of procedural and legislative complexity and ambiguity, shareholders very rarely, if ever, use these largely theoretical powers to appoint new directors.

## **Impact of Votes on Remuneration Reports**

Recent regulations require that a company's remuneration policy, as included in the annual remuneration report, which is part of the annual report, must be put to shareholders at the annual meeting for approval. If shareholders were to vote against the policy, this would not directly affect the terms of employment or compensation of the individual directors. However, it likely would put pressure on the board to review those terms.

In July 2003, that is precisely what happened in the case of GlaxoSmithKline at its annual meeting when shareholders refused to approve the remuneration report, largely because they were unhappy about the terms of compensation for the US CEO. In response, the company's board stated that it would commission an outside report and report to shareholders on this matter

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in the near future. Other than this case, as far as the author is aware, shareholders have approved remuneration reports since the new rules took effect in 2002.

## **How Might Board Change Be Effected in the United Kingdom?**

It is too early to tell how the new Combined Code will play out, given that it will start to really take hold after November 2003. The new Combined Code is designed to make the process of appointment more rigorous and professionally done and to require search consultants to look for different pools for talent: directors of private companies, many more women and ethnic minorities drawn from the professions and middle management, and large charities.

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### **In practice, larger shareholders are reluctant to intervene and do not make suggestions to nominating committees.**

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We can expect to see that nominating committees will start to draw up more complete job descriptions to fill skills needed on a particular board. We can also expect that there will be more open advertising for directors. The notion of an annual board and individual director appraisal has yet to be tested, but we can expect to see a process of change as ineffective directors are forced by chairs to retire. We also can expect to see more pressure being brought to bear on the chairs of nominating committees. It should be noted that it is now becoming the general practice, reinforced by the requirements of the Combined Code, for the chair and CEO positions to be occupied by different people. Accordingly, the chair of the nomination committee usually will be the chairman of the company or the lead independent director.

For the immediate future, the traditional method of “behind the scenes” informal pressure from large shareholders on the chairs or lead directors of non-performing boards will likely continue to be a rare, but still the most often used, weapon for change. There have been some recent examples where institutional shareholders have brought about removal of directors using that type of pressure, but not any replacements that have been influenced by shareholders. In practice, larger share-

holders are reluctant to intervene and do not make suggestions to nominating committees. They increasingly express dissatisfaction about performance or pay to chairs and chief executives (these days, as mentioned above, mostly two separate individuals) and occasionally to lead independent directors, but they leave it to the chair and board as a whole to make changes in officer or board composition.

As examples, in 1999, the largest activist fund, Hermes, insisted to the chair of Mirror Group that its CEO be removed after he defied shareholder value principles in obstructing a bid for the company. Hermes made a big splash of this in public, “*pour encourager les autres.*” It was thought to be the first time such an intervention had occurred in the United Kingdom. Another example is when a UK power generation company was influenced to change the chair after the lead independent director went to shareholders with his concerns. In 2001, following the Marconi share price blood bath when it had bet the ranch on a huge acquisition US technology spending spree, the chair, chief executive, and CFO were pressured into resigning. In 1999, the chair and CEO of Railtrack were forced to resign after a series of rail crashes that killed many people and resulted from inadequate investment in the rail system. All in all, these are rather rare instances of shareholder activism in the United Kingdom.

It is singular that neither the UK Company Law Review (1999 to 2002) nor the resulting draft clauses intended for a new Companies Act (no existing timeline for this, but thought to have been shelved until at least 2005) proposed any changes to the cumbersome process under the Companies Act 1985 for removal and appointment of a director. However, under the proposed new Companies Act, it will be easier for shareholders to convene meetings of shareholders and place resolutions before the company, including (it is presumed) resolutions that directors be appointed or removed.

However, the government has threatened legislation that would compel institutional shareholders to vote at annual and other meetings of the company. But it is unrealistic to expect any legislation if at all before 2005. To the credit of the current government, when it threatened legislation to compel fuller disclosure of directors’ pay and nobody paid attention, the government legislated. So the threat is not to be ignored. The only point of this observation is that the annual re-election ritual might one day become a real focus for change if shareholders at last decide to cast their votes for re-election resolutions.

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To US corporate governance practitioners, the UK system and its lack of legislative bite, relying as it does on codes of practice, look weak. “A self-perpetuating oligarchy”, as one commentator has put it. However, if the Combined Code is taken seriously and shareholders begin to more energetically exercise their powers of voting, we may begin to see a much more robust approach to dealing with boards. The current UK government has an appetite to legislate and will do so if institutional investors fail to step up to the plate and vote.

## Notes

1 On the other hand, shareholder proposals are more common, although not nearly as shareholder proposals under Rule 14a-8 in the United States (for example, the UK Shell Oil environmental resolution was put up by shareholders some 10 years ago and still lives on). As in the United States, these resolutions are not binding on the board.

2 The significance of this provision is that elsewhere in the Combined Code companies are required to compose their boards so that at least one-half comprise “independent” directors, as defined (rigorously) in the Code.

## Shareholder Access in Canada

by William J. Braithwaite

For its upcoming shareholder access rights initiative, one of the ways that the Securities and Exchange Commission (SEC) may proceed is through a form of proposal mechanism to allow for the nomination of directors. That right has existed in Canada for more than 30 years.

Securities law in Canada is a matter of provincial jurisdiction. Each of the 10 provinces and three territories has its own securities act; for the most part, they are quite similar. Similarly, the Canadian Securities Administrators, the organization of provincial and territories securities regulators, has developed numerous cooperative and mutual reliance systems and currently is engaged in a uniform securities legislation initiative.<sup>1</sup>

Corporate law in Canada is both a matter of provincial and federal jurisdiction. Corporations incorporated under federal law, like provincial corporations, are subject to provincial securities laws. There also are various areas of duplicate corporate and securities law regulations. For example, proxy solicitation in Canada is regulated under various provincial and federal corporate statutes as well as under the provincial securities statutes.

### Nominations by Shareholder Proposal

In Canada, shareholders can nominate directors through binding shareholder proposals. Shareholder proposals are regulated in Canada under corporate law. Securities legislation does not grant a proposal right. A proposal right was introduced into federal corporate law in 1970 and was modeled on the US SEC's Rule 14a-8, originally established in 1942.<sup>2</sup> Unlike the position in the United States, the Canadian proposal mechanism can be used to nominate directors.

The right is expressly quoted under subsection 137(4) of the Canada Business Corporations Act<sup>3</sup> (CBCA) and subsection 99(4) of the Ontario Business Corporations Act<sup>4</sup> (OBCA), which state the following:

A proposal may include nominations for the election of directors if the proposal is signed by one or more holders of shares representing in the aggre-

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gate not less than five per cent of the shares or five per cent of the shares of a class of shares of the corporation entitled to vote at the meeting to which the proposal is to be presented, but this subsection does not preclude nominations made at a meeting of shareholders.

The right to nominate directors through the proposal mechanism resides with registered holders of shares.<sup>5</sup> This is also the case under the OBCA.

If a proposal is made, the management information circular would include both management's nominees and the nominees of the person making the proposal. The corporation, if requested to do so, must include in its management information circular or attached to it a statement in support of the proposal, which together with the proposal itself cannot, under the CBCA, exceed 500 words (OBCA, 200 words). So, if a shareholder nominee receives more votes than a management nominee, the shareholder nominee joins the board.

Notwithstanding that these provisions have been in place for some time, there is little experience in Canada with the nomination proposal provision.

### Nominations from the Floor

Shareholders generally also have a right under Canadian corporate law to nominate a director from the floor of a shareholders meeting.<sup>6</sup> Shareholders have such a right through an interpretation of the shareholder proposal provision, which, for example, in the OBCA states that the right of the holder of 5 per cent of the shares to effect nominations "does not preclude nominations made at a meeting of shareholders."<sup>7</sup>

Not all Canadian corporations' statutes provide such a right. Under the corporate laws of the provinces of Saskatchewan,<sup>8</sup> Manitoba,<sup>9</sup> and Newfoundland,<sup>10</sup> the reference to nominations made at a meeting of shareholders applies only to private corporations. In the case of *Clearwater Fine Foods Limited v FPI Ltd.*,<sup>11</sup> the Newfoundland Supreme Court was asked to determine whether, under the Newfoundland Corporations Act,<sup>12</sup> nominations by anyone other than the board had to be

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made through a proposal. The court ruled that, while nominations at a meeting were not permitted, a shareholder could make nominations through the proposal mechanism or through a dissident proxy solicitation.

## Disclosure of Nominating Committee Activities

Under the proxy solicitation disclosure requirements imposed by securities and corporate laws, little disclosure is expressly required with respect to the nomination process.<sup>13</sup>

So far, even though there have been rulemakings relating to the Sarbanes-Oxley Act of 2002 (SOA), the Securities Act (Ontario)<sup>14</sup> has not been amended to grant the OSC rulemaking authority with respect to the nomination process.<sup>15</sup> Nor are there any other proposed amendments to provincial securities legislation or corporate legislation with respect to nominations.

The Toronto Stock Exchange (TSX) does, through its disclosure rules, speak to the nomination process. In 1994, the TSX, following the recommendation of the Final Report of the Toronto Stock Exchange Committee on Corporate Disclosure, adopted a number of corporate governance guidelines.<sup>16</sup> Listed issuers are not required to comply with the guidelines; instead, they must report annually in their proxy circular or annual report as to whether they are complying with the guidelines. While the TSX does not prescribe corporate governance practices, the effect of mandating disclosure has been to effect reform in corporate governance practices.

With respect to the nominating process, Guideline 4 of the TSX current governance guidelines provides that the board of directors should establish a board committee composed exclusively of outside directors (*i.e.*, non-management directors, a majority of whom should be unrelated directors effectively charged with oversight responsibility for the nomination process).<sup>17</sup> The nominating committee's mandate would include recommending qualified candidates for the board and annually reviewing the credentials of the nominees up for re-election. Guideline 5 adds that every board of directors should create a process for its nominating committee to adhere to in evaluating the effectiveness of individual directors, committees, and the board as a whole.

## Nominating Committee Regulatory Initiatives

In November 2002, in response to both SOA and the recommendations in the Final Report of the Joint Committee on Corporate Governance (informally known as the Saucier Committee),<sup>18</sup> the TSX proposed additional, more stringent revisions to the guidelines along with practice notes and new continued listing requirements.<sup>19</sup>

Under the TSX's proposed guidelines, a practice note has been added on the subject of nominating directors, which states that the full board should engage in a disciplined process to pinpoint the kinds of skills and qualifications it desires in new board members.<sup>20</sup> Upon the identification of prospective nominees, either the chair of the nominating committee or another director could be selected to recruit candidates on behalf of the board. The proposed amendments to these guidelines have not been finalized.

In fact, on September 19, 2003, David Brown, Chairman of the OSC, announced that the OSC will soon introduce new guidelines for corporate governance.<sup>21</sup> The OSC is finalizing a list of recommendations to be included in a policy that will require boards to disclose their corporate governance practices. Among other things, this continuous disclosure policy will cover nominating committees. In addition, the OSC plans to take over the responsibility for setting corporate governance guidelines from the TSX.

## Notes

1. Canadian Securities Administrators—Uniform Securities Legislation Project, "Blueprint for Uniform Securities Laws for Canada" (2003) 26 OSCB 943 at 948.
2. *See*, Wayne D Gray, *The Annotated Canada Business Corporations Act*. (Toronto, Carswell, 2001) 1-291.
3. R.S.C. 1985, c. C-44.
4. R.S.O. 1990, c. B.16.
5. A CBCA reform process was launched in 1995, which culminated in the passing of Bill S-11. Bill S-11 resulted in significant amendments to the shareholder provisions in the CBCA. *SI/2001-114.S.C.* 2001, c.14, formerly known as Bill S-11, An Act to Amend the Canada Business Corporations Act and to Amend Other Acts in Consequence, passed third reading in the House of Commons on June 11, 2001, and received Royal Assent on June 14, 2001.
6. However, under Can. Reg. 2001-512—CBCA Regulations, 2001, § 56 states that a "form of proxy shall not confer authority to

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vote in respect of the appointment of an auditor or the election of a director unless a bona fide proposed nominee for the appointment or election is named in the form of proxy, management proxy circular, dissident's proxy circular or proposal under section 137 of the Act.”

7. *Supra* n.3 § 137(4). Identical wording is used under § 99(4) of the OBCA.

8. *See* §131 (4) of the Saskatchewan Business Corporations Act, R.S.S. 1978, c. B-10.

9. *See* § 131(4) of the Manitoba Corporations Act, 1976, c. 40, C.C.S.M., c. 225.

10. *See* § 226 of the Newfoundland Corporations Act, R.S.N. 1990 c. C-36.

11. *Clearwater Fine Foods Ltd. v FPI Ltd.*, (2001), 15 B.L.R. (3d) 124, 603 A.P.R. 195, 200 Nfld. & P.E.I.R. 195, 2001.

12. *Supra* n.8.

13. While disclosure in respect of management's nominees is required under Can. Reg. 2001-512—CBCA Regulations, 2001, and Form 30, Item 5 under R.R.O. 1990, Regulation 1015 to the Ontario Securities Act, no disclosure is explicitly required with respect to the nomination process.

14. R.S.O. 1990, c. § 5.

15. Last year, the Securities Act (Ontario) was amended to grant the Ontario Securities Commission (OSC) rulemaking authority with respect to a number of matters that arise under the Sarbanes-Oxley Act of 2002, such as audit committee functions and compo-

sition, CEO/CFO certifications, internal controls, and disclosure controls and procedures. On June 27, 2003, the OSC and other Canadian securities regulators proposed rules with respect to audit committees and certifications. Notice of Request for Comments Proposed Multilateral Instrument 52-108 Auditor Oversight, Proposed Multilateral Instrument 52-109 Certification of Disclosure in Companies' Annual And Interim Filings and Proposed Multilateral Instrument 52-110—Audit Committees (2003) 26 OSCB 4884. Other rules are to follow.

16. *See* “Where Were the Directors? Guidelines for Improved Corporate Governance in Canada,” (commonly referred to as the Dey Report), <http://www.icsacanada.org/dey%20report.pdf>.

17. *See* TSX Company Manual Corporate Governance, § 474.

18. A copy of the Saucier Report is available at [http://www.jointcomgov.com/index.cfm/ci\\_id/8113/la\\_id/1.html](http://www.jointcomgov.com/index.cfm/ci_id/8113/la_id/1.html).

19. The proposed guidelines are available at [http://www.tse.com/en/tradingServices/docs/2450Apr2602\\_Request\\_for\\_Comments.pdf](http://www.tse.com/en/tradingServices/docs/2450Apr2602_Request_for_Comments.pdf).

20. TSX Request For Comments—Corporate Governance Policy—Proposed New Disclosure Requirement and Amended Guidelines (2002) 25 OSCB 2476 (April 26, 2002). Proposed guidelines can also be found at <http://www.tse.com/en/mediaNews/newsreleases/news2355.html>.

21. *See* Peter Fitzpatrick, “OSC Finishing Reforms to Governance: Guidelines, Not Rules,” *National Post*, 20 Sept. 2003, FP05; and Janet McFarland, “Independent Has Many Meanings; Determining Directors' Connection to Management Is All Over the Board,” *The Globe and Mail*, 24 Sept. 2003 B9.

## Shareholder Access in Germany

by *Matthias Terlau*

In Germany, the main legal forms of corporations are either the simple limited liability company (GmbH) or the stock corporation (*Aktiengesellschaft* or AG). In a group structure in Germany, one would usually find a stock corporation as the parent company with one or many limited liability companies as subsidiaries. One of the reasons for such structure is that in a GmbH, the appointment and removal of directors is solely decided by the shareholder(s). In an AG company, any shareholder has a right to propose a nominee to the supervisory board, but it is the supervisory board alone that makes nominations for the management board that have day-to-day control of the company.

### The GmbH

In a GmbH, the shareholders appoint and remove the directors by a majority vote in a shareholders' meeting that is convened following the period of notice stipulated in the articles of the particular GmbH. However, if all shareholders consent, an *ad hoc* meeting may be convened and an appointment decision taken, which would then become immediately effective. The appointment and the removal of a director must be registered in the local commercial register, although registration is not a prerequisite for the effectiveness of an appointment or removal.

This system means that it is the shareholders themselves who ultimately retain the reigns of power in a GmbH, a system that is tried and trusted in the context of smaller privately owned companies in many different jurisdictions, including the United Kingdom.

### The *Aktiengesellschaft*

The governance structure is more complex for an AG company, which has a two-tier board system. The management board (*Vorstand*) consists of the directors who are in charge of managing the company's affairs. By contrast, the supervisory board (*Aufsichtsrat*) oversees the activities of the management board.

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Members of the management board are appointed by the supervisory board. Shareholder approval is not involved for these appointments. At face value, this could appear as though shareholders have minimal involvement with the composition of the board; parallels with UK company law are obvious.

However, the role of the shareholder in ensuring corporate accountability comes once again to the fore as it is the AG shareholders that appoint the members of the supervisory board. If the articles of the AG do not stipulate alternative voting requirements, a simple majority of shareholder votes at a general meeting of shareholders is sufficient to elect supervisory board members. The procedure for such elections is that the management board convenes a shareholders' meeting and submits recommendations for new supervisory board members to fill vacancies as they arise. Shareholders have the theoretical power to make such nominations to the supervisory board,<sup>1</sup> although the German Panel on Corporate Governance recognizes that, in practice, it is the supervisory board that makes the nominations.

Following appointment, all supervisory board members are thereafter independent of shareholders, even if nominated by them. Instead, they owe a fiduciary duty of loyalty and care to the company. On occasion, the articles of association are drafted so as to permit certain shareholders (such as venture capitalists) a special right to appoint a member of the supervisory board automatically.

The role of the shareholder is equally important for removals from the boards of a German AG company. Members of the supervisory board can be removed by a shareholders' resolution with a 75 percent majority of votes (unless the company's articles provide otherwise). A removal of all, or a number of members, of the supervisory board is common in takeover transactions, as the acquiror wishes to assume control of all aspects of the target's internal governance.

Members of the management board can be removed by the supervisory board on various statutorily defined grounds, including a material violation of their fiduciary duties, incompetence, significant disputes between

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executive directors and the supervisory board about future company strategy, and a shareholder vote of no confidence in the director.

However, despite the apparent benefits of a dual board system, the 1995 International Bar Association conference highlighted a very different reality involving suspect appointment procedures (historically, strong long-term relationships with German banks have frequently resulted in a domination of the supervisory board by a chairman who is at the same time banker, lender, and majority shareholder representative, with the obvious conflicts of interest that such diverse roles entail) and the fundamental principle that under German law, the companies are run for the benefit of the company (including the employees and management) rather than shareholders.

In response to such criticism, in 2002, the German government established the Commission of the German Corporate Governance Code that set out clear rules to be followed by supervisory and management boards of listed German companies and which is recommended even for non-listed companies. In addition to establishing best practices to be adhered to, the Code requires that companies failing to comply with its provisions must declare this non-adherence and explain the reason for non-compliance annually in its financial reports.

One additional proviso, which again promotes a culture of openness and disclosure and is very much akin

to that required in the United Kingdom, is that German stock markets rules require publicly traded AG companies to notify the market of appointments and removals of members of the management board if the board member plays a key role in the company's management, because such an event could affect the stock's trading value.

## Conclusion

It is apparent that in continental Europe, the commercial code of the major countries has promoted a culture of management accountability to shareholders and has even introduced two-tier board structures as fail-safe mechanisms. The recent introduction of the Code of Best Practice for German Corporate Governance mirrors the concept of best practices found in the UK Combined Code and seeks to redress the problems, perceived or otherwise, where undocumented, unofficial pre-meeting meetings were the primary avenues for true management of the company.

Steps to produce a pan-European code of acceptable corporate governance practices have commenced, though given the fundamental differences at the root of the various European legal systems, uniform statutory accountability is still far away.

## Note

1. Under § 127 of the Aktiengesetz, the Stock Corporation Law.

## Shareholder Access in France

by *Armelle Maître and Dominique Mussy*

French company law provides that a limited liability company (*Société anonyme* S.A.) may be managed either by traditional board of directors (*conseil d'administration*) or by a management board (*directoire*) itself functioning under the control of supervisory board (*conseil de surveillance*). The company's articles of association set out which particular management structure has been adopted by the company concerned.

As explained below, when the two-tier board system has been adopted, significant shareholders do have a mechanism to nominate directors themselves. One or more shareholders representing at least 5 percent of the share capital can demand the inclusion of nominations in the agenda for a general meeting of shareholders, thereby proposing favored appointees. However, the chairman of the board can indirectly interfere with the ability of a shareholder nominee to be elected, and this combined with the limited popularity of the two-tier board system means in effect that the right to nominate is not as absolute as it seems.

### Management Solely by Board of Directors (*Conseil D'administration*)

This management structure of an S.A. is quite similar to that of a UK limited liability company, in that the board has overall decision-making power and can appoint fellow directors as necessary (with appointment decisions subsequently ratified by the shareholders). The appointment procedures themselves mirror those in the United Kingdom (*i.e.*, it is the board that convenes a general meeting of shareholders at which the board makes the proposals for the appointment of any new directors). Such a hands-off approach is widely adopted for convenience, although French law does permit a more interventionist method of regulating the corporate activities in a limited liability company with the option of a supervisory board structure.

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### Management by Management Board (*Directoire*) and Supervisory Board (*Conseil D'administration*)

French law also permits an S.A. to be controlled by a management board (*directoire*) operating under the scrutiny of a supervisory board (*conseil de surveillance*). In such a structure, it is the supervisory board that represents the interests of shareholders. Although on its own the supervisory board has no management powers, it oversees the actions of the management board and reports back to a meeting of shareholders.

Members of the management board are themselves appointed by the supervisory board; the theory being that this allows shareholders interests to be paramount when managing the company.

A March 2002 survey showed that only 4 percent of all French S.A. companies have opted for the two-tier board system, although the proportion of listed companies that have followed this route is much greater. Indeed, of the top 40 companies listed on the French stock exchange (CAC 40), 20 percent of these S.A. companies are governed by the two-tier structure, reflecting perhaps the recognition of a need for greater accountability and transparency of publicly owned companies.

### Appointment of Directors or Members of Supervisory Board

The first members of both types of boards are appointed at the initial meeting of the company's shareholders. Thereafter, the only way to appoint directors or members of a supervisory board is following an affirmative vote at a shareholders' meeting. Appointment decisions are valid if the shareholders present or represented hold at least 25 percent of the voting shares and pass the appointment by majority decision.

There are full and frank discussions regarding the merits of each candidate seeking election. The shareholders are entitled to request a host of personal information including age, skills, and professional appointments held

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during the previous five years (including any French or overseas companies). Shareholders also can request information on the level of shares held by the candidate in the company.

Substantial shareholders have additional powers. One or more shareholders representing at least 5 percent of the share capital can demand the inclusion of nominations in the agenda for a general meeting of shareholders, thereby proposing favored appointees. Any such demand must be sent to the chairman of the board of directors or the management board, as applicable, 25 days prior to the meeting for private companies and 20 days prior for public companies. French law does not allow the chairman to refuse to include any shareholder nominations, but in reality, the chairman can exercise his disapproval in a less direct fashion by informing the other voting shareholders of his opinion as to proposed nominee.

To date, no official statistics have been compiled documenting the frequency of any shareholder intervention or citing any chair's disdain for shareholder-led nominations. From experience, it is suggested that these theoretical powers are seldom used. Instead, undocumented

unofficial meetings often reconcile any differences of opinion between major shareholders and management without the need for shareholders to intervene at a shareholders' meeting.

It is worth reiterating that in the two-tier management structure of an S.A., shareholders have no power to propose an appointment to the management board; only the supervisory board has such capacity. The supervisory board, having been selected and appointed by the shareholders, can undertake the hiring and firing without the need for active intervention by the shareholders on a day-to-day basis.

### **Removal of Directors or Members of Supervisory or Management Boards**

Directors or members of either the management or supervisory boards may be removed from office at any time following a vote of the shareholders at a general meeting of ordinary shareholders, even if such removal was not included on the agenda. This enables disgruntled shareholders to exercise the ultimate veto if management is failing to perform adequately.

## Shareholder Access in Australia

by *Andrew Arnold*

While the Australian Stock Exchange (ASX) has recommended that all companies listed on the ASX should have a nomination committee and should disclose details about their nomination committees processes, there is no mechanism similar to the one being considered by the US SEC to increase shareholder involvement in the nomination process. However, it is possible that the Australian regulators will consider whatever initiatives that the US SEC ultimately adopts, so it is conceivable that proposals specifically addressing shareholder involvement in the nomination process may emerge in the future.

### Background

Recently, there have been several initiatives in Australia concerning corporate governance. However, the Australian reforms have not been as comprehensive as the recent US reforms for various reasons, including:

1. While some high profile Australian corporations have become insolvent in recent times, Australia did not experience the crisis of confidence in corporate reporting and financial practices experienced in the US following the collapses of Enron, WorldCom, and other corporations.
2. The Australian approach to regulation of public companies has always been different from the US approach. For example, the Australian approach is to require shareholder approval of certain key transactions (such as related-party transactions); whereas the US approach tends to prohibit specified transactions.
3. Australian corporate regulation was already more stringent than US corporate regulation in some key areas.

In March 2003, the ASX released a detailed set of Corporate Governance Principles to apply to all Australian listed public companies and listed trusts.<sup>1</sup> Importantly, the principles are not mandatory. Instead, they adopt an “if not, why not” approach.<sup>2</sup> In other words, if a listed public company departs from the Corporate Governance Principles, it is required to specifically disclose the departure and to give reasons.

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### Nomination Rights

The specific ASX Corporate Governance Principles relating to nomination rights are as follows:

1. Listed public companies should establish a nomination committee consisting of a minimum of three members, the majority being independent directors.<sup>3</sup> The Nomination committee should be chaired by the chair of the board or an independent director.
2. The nomination committee should have a formal and transparent procedure for the election and appointment of new directors. The nomination committee should consider developing and implementing a plan for identifying, assessing, and enhancing director competencies.
3. There is no mandatory requirement, or ASX recommendation, concerning procedures to enable shareholders to make suggestions directly to the nomination committee. In practice, the deliberations of the Nomination Committee are dominated by the members of the nomination committee, which typically consists of the existing directors or persons associated with the existing directors.
4. The following material should be made publicly available, ideally by posting it to the company’s Web site in a separate “Corporate Governance” section:
  - A. Description of the procedure for the selection and appointment of new directors;
  - B. The Charter of the nomination committee or a summary of the role, rights, responsibilities, and membership requirements for the nomination committee; and
  - C. The nomination committee’s policy for the appointment of directors.
5. Some additional material should be included in the “Corporate Governance” section of the company’s annual report. However, this is mostly background information concerning the Directors and the members of the nomination committee.

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In addition, various rights exist under the ASX Listing Rules, the Corporations Act, and the provisions of a typical company constitution. These rights are as follows:

1. A listed company must hold an election of directors each year.<sup>4</sup> The Managing Director is the only director who may hold office for more than three years without standing for re-election.<sup>5</sup> Typically, a company's constitution will provide that not less than one-third of the directors must retire from office each year (but are eligible for re-election). The directors to retire in a particular year are those that have held office for the longest period since they were last elected.
2. The appointment of directors must be voted on individually unless the company unanimously agrees that two or more directors may be elected by the same resolution.<sup>6</sup>
3. A company *must accept* nominations for the election of directors received up to 30 business days before the date of a shareholders meeting at which directors may be elected.<sup>7</sup> The company may accept nominations closer to a shareholders meeting in accordance with its constitution.
4. While the incumbent directors are entitled to use the resources of the company to inform shareholders of the choice of candidates, they generally are not entitled to use the company's resources to actively advance the election of particular candidates at the expense of others.<sup>8</sup> There is an exception to this principle if the election of a particular director would harm the business or reputation of the company or it would contravene a statutory provision.
5. Typically, the procedure in the company's constitution for nominating a candidate is relatively simple. Each candidate must be proposed by one shareholder and seconded by another shareholder. Typically, no shareholder may propose more than one candidate. However, a shareholder may second more than one candidate.
6. If a shareholder's candidate for election to the board is validly nominated, a resolution concerning the appointment of that candidate must be included in the notice of meeting and on the proxy card, and the resolution must be voted on at the next shareholders meeting.

There is currently no requirement to disclose the procedures relating to nominations for the election of directors (other than the recommended practice of describing the procedure for the selection and appointment of new directors on the company's Web site). In practice, the nomination process is dominated by the nomination committee and the board. For many Australian listed companies, the right of the general shareholders to nominate board candidates will be actively used only in exceptional circumstances (such as when the company is underperforming or where rival factions exist within the shareholder list).

## Conclusion

As can be seen, comprehensive procedures already exist under the Australian Corporations Act for shareholders to nominate Board candidates. In practice, these rights are often underused, partly for the following reasons:

1. There is no mandatory requirement to inform shareholders about the procedures relating to nominations in the period leading up to a shareholder meeting;
2. While the new ASX Corporate Governance Principles recommend disclosure of nomination procedures on each company's Web site, compliance with this principle is not mandatory; and
3. Shareholder apathy often means that the nomination process is dominated by the nomination committee and by incumbent directors.

## Notes

1. ASX Corporate Governance Council, "Principles of Good Corporate Governance and Best Practice Recommendations," (Mar. 2003) published by the Australian Stock Exchange Limited.
2. *Id.* at p.5.
3. *Id.* at pp.21-25.
4. ASX Listing Rule 14.5.
5. ASX Listing Rule 14.4.
6. Corporations Act § 201E.
7. ASX Listing Rule 14.3.
8. *Advance Bank Australia Ltd. v. FAI Insurances Ltd.*, (1987) 9 NSWLR 464.

## Shareholder Access in Hong Kong

by *Simon Lai and Gavin Nesbitt*

The existing listing rules in Hong Kong do not require listed companies to establish nomination committees nor do they make any recommendations generally regarding whether the board should appoint or reappoint directors at all. As a result, listed companies are free to establish their boards without regard to matters such as director independence, and shareholders have no mechanisms to nominate directors themselves.

### The Stock Exchange Consultation Paper

However, corporate governance reform is happening in Hong Kong. In January 2002, The Stock Exchange of Hong Kong Limited (SEHK) issued a consultation paper that proposed amendments to the Listing Rules relating to various corporate governance issues (Consultation Paper). Specifically, there were various proposals relevant to the issue of director nominations. These included:

- As a minimum standard in the Code of Best Practice contained in the Listing Rules, listed companies should establish a nomination committee comprising a majority of independent non-executive directors (INEDs). As proposed, this would not be a mandatory requirement.
- The Code of Best Practice should be amended to include the principal functions of the nomination committee. These would include making recommendations to the board on all appointments of directors, evaluating the performance of the directors, and assessing the independence of INEDs.
- The Listing Rules should be amended to require disclosure by issuers of various information in their annual reports (*e.g.*, the role, function, and composition of a nomination committee (if any) or any reason for not having one).

The Consultation Paper also noted the following:

- Nomination committees are of considerable assistance to the board in making appointments or re-appointments of directors and ensuring a formal and transpar-

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ent procedure for making such appointments or re-appointments.

- Nomination committees may select fewer affiliated outsiders to the board.
- Nomination committees may be formally vested with the responsibility to consider whether existing directors should be re-appointed by considering their contribution and performance.

### The Consultation Conclusions

Following the Consultation Paper, consultation conclusions were published by the SEHK in January 2003 that modified the proposal by recommending the establishment of a nomination committee comprising a majority of INEDs as a *recommended good practice* in the Code of Best Practice. Thus, the language was softened from a “minimum standard” to a “recommended good practice.” In addition, under the new proposal, listed companies were no longer required to disclose the reason for not establishing a nomination committee in their report on corporate governance.

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**The language was softened from a “minimum standard” to a “recommended good practice.”**

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These two changes were made due to negative commentary from the majority of respondents. Some respondents believed that, since most listed companies in Hong Kong are family owned and controlled companies, it was not realistic to assume that those controlling shareholders would give up their right to appoint board members. Other respondents noted that the proposal would disenfranchise the rights of controlling shareholders to appoint and remove directors. So far, no further change has been made to the Listing Rules after the consultation conclusions, and the open issues are still being discussed.

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## **Corporate Governance Review Phase II Consultation Paper**

In June 2003, the Standing Committee on Company Law Reform (SCCLR) issued its “Corporate Governance Review Phase II Consultation Paper,” which proposed enhancements to Hong Kong’s corporate governance regime for Hong Kong incorporated companies. Hong Kong incorporated companies are limited liability companies incorporated in Hong Kong, which comprise of both public and private companies. Therefore, the effect

of this Consultation Paper is not limited to listed companies in Hong Kong. It also applies to private Hong Kong incorporated companies.

The SCCLR’s proposals relate to numerous aspects of the board’s functions and composition, including directors’ roles, duties, qualifications, training and remuneration, board procedures, and board committees. In addition, they deal with shareholders’ rights and conflicts of interests. In its proposals, SCCLR holds the view that establishing nomination committees should be regarded as a best practice.

## Shareholder Access in Singapore

by *Rheinny Wiraatmadja*

The Asian financial crisis in 1997 served as a timely reminder to the Singapore government of the importance of corporate governance. In view of the government's commitment to Singapore's role as Asia's leading financial hub and in order to remain internationally renowned for its anti-corruption stance, the government is conscious of the requirement for and maintenance of high standards of corporate governance.

Consequently, three private-sector-led committees, such as the Committee on Company Legislation and Regulatory Framework (CLRFC), the Committee on Accounting and Disclosure Standards (DASC), and the Committee on Corporate Governance (CGC), have been established to review and reexamine Singapore's corporate regulatory framework, disclosure standards, and corporate governance reforms, respectively.

This article discusses the nomination process for board candidates in companies listed on the Singapore Exchange (SGX) when the Singapore government has heightened its commitment to facilitating corporate governance. As the law currently stands, the Singapore Corporate Governance Code (Code) prescribes the general requirements for forming a nominating committee.

However, although there are those who are of the view that shareholders (or alternatively, an employee who is not a director) should be included on the nominating committee,<sup>1</sup> the Code does not contemplate shareholder involvement and participation in the nomination process. Unlike the current US SEC initiatives, it is unlikely that Singapore will issue proposals to require nominating committees to consider shareholder participation anytime soon.

### Background

While Singapore is endeavoring to reform corporate governance practices, the development of corporate governance in the country is a relatively recent move compared to countries such as the United Kingdom, United States, and Australia. The CGC considered the corporate governance approaches adopted by these

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countries when considering a suitable approach for Singapore.<sup>2</sup> However, having said this, instances of corporate collapses in the country have not been as significant<sup>3</sup> compared to the collapses of Enron and WorldCom in the United States or the HIH Insurance group in Australia.

In 1999, the Singapore Ministry of Finance, together with the Monetary Authority of Singapore and the Attorney-General's Chambers, formed the CLRFC, DASC, and CGC. Corporate governance in Singapore is mainly regulated and reinforced by the Code as it was introduced by the CGC in April 2001.<sup>4</sup> The aim of the Code is to encourage companies listed on the SGX to enhance shareholder value through good corporate governance and to provide a description of their corporate governance practices.<sup>5</sup>

While the Code is intended to merely be a guideline, listed companies are required to disclose their corporate governance practices and provide explanations for deviations from the Code in their annual reports for annual general meetings. This requirement took effect for meetings held after the beginning of 2003.<sup>6</sup> Therefore, a large part of the Code is based on the principle of self-governance where the onus is imposed on the companies to bear the responsibility for adopting corporate governance practices appropriately suited to their circumstances. It is then up to the market to decide which companies practice good corporate governance.<sup>7</sup> The approach of self-governance adopted by the Code is similar to that reflected in the ASX Corporate Governance Principles for Australian listed public companies and listed trusts.<sup>8</sup>

The Code in Singapore is split into four main categories:

1. Board matters;
2. Remuneration matters;
3. Accountability and audit; and
4. Communication with shareholders.

Furthermore, the Code prescribes the following board committees:

- Audit Committee;
- Remuneration Committee; or
- Nomination Committee.

Additional committees may be established, and they include:

- Executive Committee;
- Risk Management Committee;
- Corporate Governance Committee.

## Nominating Committee

According to the Code, for a board to be effective there should be a formal and transparent procedure for the appointment of new directors to the board. As a principle of good corporate governance, all directors should be required to submit themselves for re-nomination and re-election at regular intervals.<sup>9</sup> All re-appointments should not be automatic<sup>10</sup> and to achieve this, companies should form a nominating committee to deliver recommendations to the board on all board appointments.<sup>11</sup>

The Code's recommendations in relation to nomination and the responsibilities of the nominating committee are set forth below:

1. There must be at least three directors on the nominating committee, a majority of whom, including the chairman, should be independent. In addition, there should be a written document that describes the responsibilities of its directors and the board generally, the details of which should be disclosed annually.<sup>12</sup>
2. When re-nominating any director, the nominating committee should consider the director's contribution and performance (for example, attendance, preparedness, participation, and candor).<sup>13</sup>
3. The nominating committee is responsible for determining on an annual basis whether a director is independent<sup>14</sup> and whether a director is able to and has been adequately carrying out his/her duties as a director of the company (especially when a director sits on multiple boards).<sup>15</sup>
4. Regarding board performance, the nominating committee should decide how the board's performance may be evaluated and propose objective performance criteria.<sup>16</sup>

5. Every board should implement a process to be carried out by the nominating committee for assessing the effectiveness of the board as a whole and for assessing the contribution by each individual director to the effectiveness of the board.<sup>17</sup>

In addition, the nominating committee is required to identify any shortage of skills, experience, and other qualities in order to nominate better-suited candidates for the purpose of establishing an effective board. Moreover, the nominating committee may advise the board on the company's general policies for the appointment of non-executive directors. It is also considered good practice for the nominating committee to set up an orientation and education program for new recruits to the board as an important part of the appointment process of new directors.

The SGX-ST Listing Manual imposes eligibility requirements for persons who wish to serve as directors of public listed companies. These requirements include the following:<sup>18</sup>

1. A person appointed to the board must be appointed on his or her merits.
2. Independent directors who are free of any relationship that would interfere with the exercise of independent judgment should be appointed to the board to represent the interests of the shareholders.<sup>19</sup>
3. For initial public offerings, the SGX requires each director and promoter (this includes substantial shareholders) to provide a statutory declaration that they have not been involved in:
  - A petition under bankruptcy laws filed against them;
  - Any unethical practices and activities that would make them unfit or improper to be a director of a public company;
  - Criminal proceedings in which they were convicted of fraud or any offense or action taken against them for any offence; and
  - Any inquiry/investigation carried out by any government, statutory authority, or body against them.

## Conclusion

The Code and, to a certain extent, the SGX-ST Listing Manual have already laid down the basis for

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shareholders to become more involved in the nomination process for board candidates. Although the Code's existence is to provide recommendations and guidance for the nomination procedure, further initiatives could be started to introduce shareholder participation and presence in the nominating committee. It will be interesting to watch whether Singapore will introduce proposals to the Code after the US SEC has adopted a shareholder access rule.

## Notes

1. For example, Kala Anandarajah, the author of *Corporate Governance Compliance* (LexisNexis Butterworths: Singapore, 2003), shares this view.
2. For example, the substance of the Code largely reflects that of the Hampel Report (UK Committee on Corporate Governance: "Final Report," 28 Jan. 1998). The Hampel Report was initiated by Sir Sydney Lipworth, the Chairman of the Financial Reporting Council. *See also* Ministry of Finance, The Committee on Corporate Governance, "Final Report and Code," 1998, Singapore, available at <http://www.mof.gov.sg/cor>.
3. An example of a corporate collapse in Singapore was the downfall of Amcol Holdings Ltd in 1996 in which the main reason for the collapse was due to irregularities in the internal management structure and system.
4. Ministry of Finance, The Committee on Company Legislation and Regulatory Framework, "Public Consultation Paper," Singapore, available at <http://www.mog.gov.sg/cor/>; Ministry of

Finance, The Committee on Accounting and Disclosure Standards, "Final Report," Singapore, available at <http://www.mof.gov.sg/cor>; and Ministry of Finance, The Committee on Corporate Governance, "Final Report and Code," 1998, Singapore, available at <http://www.mof.gov.sg/cor>.

5. Corporate Governance Committee, "Report of the Committee And Code of Corporate Governance," 21 Mar. 2001, Singapore.
6. Rule 710(2) of the SGX-ST Listing Manual.
7. Anandarajah, Kala, *supra* n.1 at II [55]-[100].
8. ASX Corporate Governance Council, "Principles of Good Corporate Governance and Best Practice Recommendations," ASX, Mar. 2003.
9. Principle 4 of the Code.
10. All directors are required to submit for re-nomination and re-election at least every three years. Guidance Note 4.2 of the Code.
11. Guidance Note 4.1 of the Code.
12. *Id.*
13. Guidance Note 4.2 of the Code.
14. Guidance Note 4.3 of the Code.
15. Guidance Note 4.4 of the Code.
16. Guidance Note 5.1 of the Code.
17. Guidance Note 5.3 of the Code.
18. Anandarajah, Kala, *supra* n.1, III [1152].
19. This is also a requirement in the Code, Principle 2 of the Code.

## Individual Director Evaluations

by *Julie K. Hoffman*

On the first anniversary of the enactment of the historic Sarbanes-Oxley Act of 2002, SEC Chairman William H. Donaldson spoke at the National Press Club, commenting that, “if companies view the new laws as opportunities—opportunities to improve internal controls, improve the performance of the board, and improve their public reporting—they will ultimately be better run, more transparent, and therefore more attractive to investors.”

A survey of institutional investors conducted by McKinsey & Co. confirms the Chairman’s conclusion that investors are interested in better corporate governance, finding that “[a]n overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards.”<sup>1</sup> In addition to the benefit of possibly being an attractive investment to investors, good corporate governance practices also may ward off individual liability for directors. Recently, the Delaware Supreme Court issued a series of opinions in cases involving the performance by directors of their fiduciary duties.<sup>2</sup> These decisions indicate an increased willingness on the part of courts to examine the behavior of directors and hold them liable for corporate malfeasance. Good corporate governance guidelines that are followed can help directors demonstrate that they are satisfying their fiduciary duties.

The past year has seen many companies’ responding to the call for change, resulting in a corporate culture that is more proactive about installing good corporate governance practices than in years past. Many boards have adopted the principles contained in the Nasdaq and NYSE proposed rulemakings in advance of the final rules being adopted and have implemented other procedures that are viewed by corporate governance ratings entities as preferred governance practices. Such preferred practices include, among others, regular meetings of independent directors without the CEO present; adopting formal procedures for the regular evaluation of CEO performance; requiring directors and senior officers to own shares of the company; and holding an annual strategy retreat for all directors.

However, many companies remain reluctant to implement several of the more radical corporate governance

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reform proposals, including: appointing a non-executive chair of the board (who is neither a current nor a former company executive); term limits for directors; and evaluation of individual directors’ performance.

It is predicted that reluctance by boards to implement individual director evaluations will soon change. The need for the nominating committee to evaluate incumbent directors has become clearer as the movement for shareholders to have a greater ability to nominate their own candidates grows. For the nominating committee to evaluate incumbent directors, it needs information, and individual evaluations is one logical way to gather this information.

This article considers the evaluation of the performance of individual board members. It will first address what institutional investors, corporate governance ratings agencies, and companies are saying about evaluating directors individually. Next, this article will review the pros and cons of evaluating directors individually. Finally, it will describe what is involved in these evaluations and the way in which companies that do evaluate their directors individually carry out the evaluations. This article concludes that, before a company adopts the practice of evaluating directors as a matter of prudent corporate governance, much thought should be put into not only the advantages and disadvantages but also the process through which the evaluations are carried out.

### What’s the Buzz?

As one would expect, many institutional investors have begun to take a position in favor of board evaluations. Certain groups specifically call for individual director evaluations. The model guidelines issued by CalPERS suggest that each board should establish performance criteria for individual directors addressing, at a minimum, attendance, preparedness, participation, and candor.<sup>3</sup> The Council of Institutional Investors Corporate Governance Policies state that individual directors should be evaluated on a regular basis and the evaluations should include “high standards for in-person attendance at board and committee meetings and disclosure of all absences or conference call substitutions.”<sup>4</sup>

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However, other corporate governance groups call for a more moderate approach to evaluating director performance. The Business Roundtables' Principles of Corporate Governance note that boards "implicitly evaluate individual directors by endorsing them for re-nomination."<sup>5</sup> The TIAA-CREF Policy Statement of Corporate Governance states that, "at a minimum, there should be an annual review by the board of its performance overall, including effectiveness of its committees, measured against criteria defined in committee charters."<sup>6</sup>

Despite the explicit position in favor of individual board evaluations by some investor groups, whether a company evaluates individual directors is not a factor that is generally considered by the several ratings systems that rank, analyze, and compare the relative corporate governance practices of public companies.<sup>7</sup> Of the leading rating entities, only Governance Metrics International considers whether individual directors conduct periodic self-evaluations. Institutional Shareholder Services considers whether the board as a whole has evaluated its performances but currently does not consider individual directors evaluations.<sup>8</sup> The Corporate Library LLC and Standard & Poor's do not consider director evaluations as a factor in their ratings.

Of all industry groups, companies have spoken out the least about individual director evaluations. Perhaps the actions of the companies themselves are the clearest statement of the current status of individual director evaluations: a joint survey of directors conducted in early 2002 by Korn/Ferry International and Corporate Board Member Magazine showed that a mere 19 percent assess the performance of individual board members, and only 33 percent of boards conduct evaluations of their board of directors as a unit. Additionally, a survey being conducted by TheCorporateCounsel.net in September 2003 shows that 20 percent of respondents conduct individual board evaluations.

## What Are the Pros and Cons of Individual Director Evaluations?

Individual director evaluations can offer many benefits, but they also may have accompanying detriments, depending upon what type and how the evaluations are performed. When first considering the issue of whether to engage in individual director evaluations, boards often engage in a discussion of the potential advantages and disadvantages of evaluations. Listed below are some of the

more often discussed pros and cons of individual director evaluations.

### Pros:

- Evaluations provide a clear assessment of a director's skills and development needs.
- Feedback on performance can help to establish clear expectations for director performance.
- A formalized evaluation procedure provides a structured forum in which to identify underperforming members, allowing for early corrective action or dismissal, if necessary.
- Evaluations can motivate directors to perform better as a director.
- Evaluations provide an opportunity for a director to reflect upon strategic objectives of the board as a whole and how his or her skill set complements those objectives.
- Performing evaluations likely increases investor confidence in corporate governance.

### Cons:

- Evaluations are likely discoverable in litigation, thereby causing directors to not be honest in their evaluations.<sup>9</sup>
- Evaluations could undermine board collegiality and board members' ability to effectively work with one another if individual directors are singled out.
- Directors may not be critical of one another, rendering the evaluation process ineffective.
- It is difficult to establish effective standards for evaluation that accurately reflect the contributions of each director, since each member possesses a different set of competencies.
- Qualified candidates may not want to join a board and current directors may not wish to remain on a board that has an evaluation process.
- Individual directors may try too hard, such as participating in areas where they have no expertise, for fear of underperforming.

## What Is Involved in a Director Review?

Individual director evaluation programs vary from company to company, depending on the methodology used and the circumstances specific to each board of directors. Of

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the various permutations of individual director evaluations, they can be grouped into three broad categories: (1) self-assessment, (2) evaluator-based, and (3) peer reviews. Some companies choose to perform only one of these categories, while others perform elements of two or three of them.

### **Self-Assessment Evaluation**

As the name implies, the self-assessment evaluation involves a director's analyzing his or her own performance, usually through the use of a questionnaire provided by the board. Depending on the board's procedures, each director may then review the results of the self-review with a designated person, such as the chair of the board, chair of the nominating or governance committee, or an independent third party.

The most obvious detraction of self-assessments is that they often are biased because they are evaluated by the director himself or herself and have limited benefits if they are not shared with anyone else. However, supporters of self-assessments argue that they can help directors reflect on their own performance without many of the detractions of the other types of individual evaluations. Further, self-assessments are sometimes used to ease the transition to a more invasive evaluation process, such as evaluator-based evaluations.

### **Evaluator-Based Evaluation**

The evaluator-based evaluation involves an evaluation of each director performed by a designated person, such as the chair of the board, the chair of the nominating or governance committee, or an independent third party. The reviews are typically based off of a list of criteria established by a committee of the board that are factors capable of being demonstrated to an observer, such as knowledge of business, knowledge of management, preparation, judgment, candor, and appearance of ethical behavior.

The evaluator-based review has the advantage of providing the company with the opportunity to offer suggestions for improved performance and identify underperforming members. However, as only one person performs the evaluator-based reviews, detractors argue that the evaluations provide only a limited review that can be biased.

### **Peer Review Evaluations**

Peer review evaluations involve the evaluation of each director by his or her non-executive director peers and is the most invasive and controversial of all individual director evaluations. Like the evaluator-based reviews, the peer reviews are typically based off of a list of criteria established by a committee of the board that are factors capable of being demonstrated to one's peers. The evaluations are completed by each non-executive director with respect to each member of the board.

Typically, the evaluations then are collected by the chair of the board, the chair of the nominating or governance committee, or an independent third party who summarizes the results and provides each director with a summary of the peer evaluations. Additionally, these summaries may be provided to the nominating committee to help ensure that only performing directors are re-nominated. These evaluations run the highest risk of undermining board collegiality if a director disagrees with his or her evaluation. On the other hand, peer review evaluations provide the opportunity for the most varied and insightful feedback on a director's performance.

### **How Do Individual Director Evaluations Take Place?**

Regardless of the method of individual director evaluation employed, the implementation of the process follows the same general format. The nominating or governance committee typically determines the process by which evaluations are carried out and the criteria for individual board evaluation. The committee then vets the proposed process and evaluation criteria with the full board prior to its adoption.

Typically, the evaluations are set up to assess both how well individual directors have functioned in satisfying their fiduciary obligations and how well the process by which they functioned worked. As the evaluation of the process usually consists of objective criteria, this evaluation is easier to establish uncontroversial standards. For example, directors are typically evaluated on attendance at meetings, punctuality, preparedness for meetings, efficient use of time at meetings, and satisfaction of any company-requirements for directors, such as ownership of shares, timely reports on § 16 transactions, and timely responses on the directors and officers questionnaires.

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However, using only objective performance criteria for each director may not provide the company with a complete picture of director performance. Companies typically also evaluate directors using non-objective criteria. The NACD's Report from the Blue Ribbon Commission on Board Evaluation advises that evaluation of individual director performance should include consideration of the execution of specific board responsibilities as well as personal characteristics and core competencies.

Typical evaluations of this nature would include, for example, an assessment of whether the board member that is designated as the "financial expert" offered his or her opinion or guidance on accounting issues when raised and where necessary or whether a director with significant expertise in the company's industry offered advice and guidance on matters in which he or she is uniquely qualified to do so.

Another decision that needs to be made when implementing individual director reviews is who is responsible for the process. There are a number of differing opinions as to who should be responsible; the choices include the chair of the board, the governance or nominating committee chair, another "lead" director, or an independent third party. The argument for the board chair performing this task is that this person typically has the most complete information about how each director performs. However, if the board chair is also the CEO, this creates, at the very least, an appearance of impropriety. In comparison, a committee chair or lead director may not have sufficient information to accurately assess how a director performs, as boards spend limited time together and what actually occurs in boards meetings may not be the best gauge of a director's contribution. But if a non-executive chair or lead director has sufficient interaction with each director, that person might be best suited to perform individual director evaluations.

There are a few companies that have disclosed the process through which they evaluate their boards of directors. Motorola, for example, uses a self-assessment questionnaire that asks directors to respond to statements about his or her individual performance, such as "I am fully prepared for board meetings," rather than implement peer review evaluations, which board members rejected.<sup>10</sup> Eastman Chemical's corporate governance guidelines require board members to perform self-assessments that are then personally reviewed with the board's chair. Finally, Intel Corporation's Corporate Governance Guidelines require the chair of the board to manage the

process of self-assessment of directors and evaluation of the board as a whole.

## Conclusion

It is clear that companies that are committed to the process of individual director evaluations can expect to receive many benefits from the process. However, it is equally clear that there are risks to performing individual evaluations. In the end, no particular approach to individual director evaluation can be singled out as the "best model" for all companies in all circumstances. At a minimum, each board should have in place a process, whether through evaluations or not, for determining that it is functioning effectively and efficiently with qualified and skilled directors.

## Notes

1. McKinsey & Co., July 2002 survey of 200 institutional investors.
2. *See, e.g.*, In re Oracle Derivative Litigation, C. A. No. 18751, Strine, V. C. (Del. Ch., June 13, 2003; revised June 17, 2003); In re Walt Disney Company Derivative Litigation, C. A. No. 15452 (Del. Ch. May 28, 2003); and In re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (7th Cir. March 28, 2003). For the sake of brevity, this article will not provide an analysis of these cases.
3. Model Guideline 13, California Public Employees Retirement Systems (CalPERS), U.S. Corporate Governance—Core Principles & Guidelines (Apr. 13, 1998).
4. Position A.9., Council of Institutional Investors Corporate Governance Policies, approved on March 25, 2002. The Council of Institutional Investors goes on in General Principle C.2 to state: "Boards should review the performance and qualifications of any director from whom at least 10% of the votes cast are withheld."
5. The Business Roundtable, Statement on Corporate Governance and American Competitiveness, at 9 (1990).
6. TIAA-CREF Policy Statement of Corporate Governance (Mar. 2000).
7. *See generally*, Matthew Brown "Companies Must Seek to Avoid the 'Junk' Governance Rating," *The Corporate Governance Advisor*, May/June 2003.
8. GovernanceMetrics International also considers whether the board as a whole is evaluated.
9. *See generally* Lois F. Herzeca and Christian S. Herzeca "The Case for Privileged Board Self-Evaluation Programs," *The Corporate Governance Advisor*, Sept./Oct. 2003. This article argues for the need to create a Delaware state statutory provision that makes privileged, non-discoverable and non-admissible board evaluations in order to gain the benefits of board evaluations.
10. David Greising, "CEO, Board Try New Methods to Revive Motorola," *Chicago Tribune*, Mar. 18, 2001 at C1.

## “Restoring Trust” or Losing Perspective?

by *Martin Lipton, Mark Gordon, and Laura Muñoz*

Much press has already been generated by the “Report on Corporate Governance for the Future of MCI,” prepared by Richard Breeden, the court-appointed Corporate Monitor for the bankrupt WorldCom/MCI, in which Breeden grandiosely proposes not only to reform scandal-plagued WorldCom/MCI but also to provide a “blueprint for a system of corporate governance” that Breeden apparently believes is applicable to all public companies. His report, entitled “Restoring Trust,” contains 78 specific recommendations intended to address WorldCom/MCI’s egregious governance and management failures, as well as other musings on topics ranging from the proper size of employee retention programs to the future of corporate financing techniques such as tracking stocks.

WorldCom/MCI is, of course, the poster child for the many corporate scandals of the late 1990s and early 2000s and a case of unprecedented financial fraud that warrants very strong responsive measures. But removed from the WorldCom situation, Breeden’s report is not really a blueprint so much as an unfiltered laundry list of virtually all of the types of reforms already considered at great length by everyone from Congress and the SEC to the stock exchanges. Individually, many of the recommendations make sense, and some have been endorsed or adopted in the Sarbanes-Oxley Act and its implementing SEC regulations, the proposed stock exchange rules, and numerous other best practices recommendations from many quarters. But many of Breeden’s other recommendations have long since been rejected by the regulators and lawmakers who have spent much time and effort considering these matters. And for good reason: Taken as a whole, Breeden’s recommendations would straightjacket and enfeeble boards of directors and undermine their ability to effectively guide their corporations—the exact opposite of what Breeden says he intends and the exact opposite of what is needed in the current environment.

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In short, calls to use the WorldCom report as a blueprint for further governance reforms must be resisted. Wanton piling on of further new rules and restrictions will be counterproductive. We discuss below some major areas of concern.

### Shareholder Control of Nominating Process

The report would require corporate governance committees to organize and recognize a shareholder committee comprised generally of representatives of the company’s 10 largest shareholders to participate in the director nomination process. If this shareholder committee does not agree with the recommendations of the governance committee (already composed solely of independent directors), then the shareholder committee would be entitled to include in the company’s proxy statement one nominee for each vacancy in that year.

As we previously pointed out (in urging rejection of the SEC proposal to grant proxy statement access to activist shareholders who want to elect their own director), it would be a serious mistake to allow this level of shareholder control over board nominations. Companies that follow Breeden’s recommendation would, among other things, risk severely disrupting the proper functioning of the board by introducing special interest directors. Special interest directors frequently have agendas that are distinct from and indeed may be contrary to the interests of the corporation as a whole or of the corporation’s shareholders other than those who nominated them.

### Over-Engineering of Board Composition and Board Functioning

The report requires: (1) that the entire board, other than the CEO, be independent (in contrast to the judgment of the NYSE and almost all others who have considered the question that a majority be independent); (2) that the company adopt detailed qualification requirements and limitations for board members, including as to the variety of experiences among the directors and the

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amount of prior public company board service, additional qualification standards for membership in each board committee (financial experience for the audit committee, compensation experience for the compensation committee, risk management experience for the risk management committee, etc.), and even more extensive experience requirements for the non-executive chairman; and (3) that at least one new director be added and one director removed to make space each year.

There is no formula for the perfect board. Strong, independent directors are essential to proper board functioning, but so too are elusive qualities such as collegiality, sense of common purpose, energy, industry knowledge, business sense, and trust. Each company, through its independent nominating committee, must have the flexibility to determine the mix of qualifications and attributes that is best suited to the specific needs of the corporation. For example, business realities and the best interests of the corporation often make it advisable for the board to include members of management other than the CEO or to include former executives or advisors to the corporation who do not meet the strict definition of independence. Excluding these categories of individuals entirely, as Breeden proposes, makes no sense. Indeed, if we consider all of the limitations and requirements that Breeden seeks to impose on committee members and the board as a whole—three directors with financial experience for the audit committee, three with compensation experience for the compensation committee, three with governance experience for the governance committee, three with risk management experience for the risk management committee, and most with extensive prior service on public company boards—it is not clear that it would even be possible for most companies to assemble such a board, let alone consider such other subjective qualities and attributes that might make for strong and valuable directors.

### **Overly Burdensome, Unduly Limiting “Reforms”**

The report proposes several requirements that would disrupt the operations of the company and limit the abil-

ity of directors to fulfill their fiduciary duties, without significantly contributing to the goal of improving corporate governance. Examples of this include: (1) a requirement that the company establish a permanent electronic town hall on its Web site where shareholders can post proposals for corporate action and a requirement that any resolution supported on the Web site by more than some minimum number of shareholders (the report mentions 20 percent) be included in the company's proxy statement for its next annual meeting; (2) highly detailed requirements regarding day-to-day management (such as detailed disclosure practices and enhanced reports of cash flows); (3) a requirement that most of the key proposals be included in the articles of incorporation, which cannot be amended without a shareholder vote; (4) strict, numerical limitations on executive compensation and executive retention decisions; and (5) prohibition against the use of effective takeover defenses (including standard shareholder rights plans and staggered boards), thereby depriving the company's board of the essential tools needed to ensure shareholders are treated fairly and equally in the takeover context.

These proposals would impose severe and unnecessary administrative burdens, threaten to divert the attention of the board and management away from the business of the corporation, and suggest an environment of governance by checklists rather than true good governance. Moreover, Breeden's recommendations would interfere with the board's ability to make the key policy and strategy decisions that the board is legally empowered and required to make.

Breeden's report is a case-specific set of recommendations seeking to right the wrongs committed by a most extreme example of corporate wrongdoing. The report should not be considered a model, or even an appropriate proposal, for corporate governance of a public corporation. We have witnessed sweeping reforms in this area in the recent past, and we must now focus our attention on implementing those reforms, on complying with their spirit as well as their letter and, most importantly, on getting back to business.

## Ethical Considerations in Internal Corporate Investigations

by William McLucas

Over the past several years, the principal program priority of the Securities and Exchange Commission's (SEC) Division of Enforcement has been the integrity of the financial reporting system on which the capital markets depend. Situations involving accounting, financial reporting abuses, and financial fraud by publicly held companies have dominated both the headlines and the SEC's attention. From Enron to Healthsouth, the litany of companies that have either announced restatements of previously issued financial statements—sometimes involving staggering amounts—or have been investigated and/or charged by the SEC, has been unprecedented.

The Department of Justice (DOJ) has launched a Task Force to investigate and criminally prosecute those involved in these alleged financial frauds, and state Attorneys General and local District Attorneys are now actively pursuing these cases as well. In addition, the passage in 2002 of the Sarbanes-Oxley Act, with its dramatic escalation of the consequences associated with violations of the federal securities laws or with obstruction of any inquiry into such violations, was, in large part, a reaction to the torrent of abuses laid bare by the recent financial scandals.

In this context, both the SEC and the DOJ have issued statements emphasizing the importance of cooperation by those under investigation, particularly public companies. One of the responses by those under scrutiny in this environment has been the resort to internal investigations, special committee or audit committee investigations, or investigations by those designated as special outside counsel. This article examines some of the issues surrounding the resort to such a process by a public company.

### Why Do an Internal Investigation

#### Compliance with Federal and State Laws

The main reason to conduct an internal investigation is to determine whether the corporation is meeting its

legal or contractual obligations on receiving credible information about a possible breach of those duties. Directors have fiduciary duties that include the obligation to self-police and to establish compliance and detection programs. To protect the corporation and themselves, directors also should create and enforce a corporate culture that will not tolerate illegal conduct.

Provisions of the Sarbanes-Oxley Act (SOA) oblige audit committees to establish procedures for receiving and addressing complaints about certain financial reporting matters. The SOA also has provisions concerning the obligation of public companies to respond properly to reports of violations of certain laws made by lawyers representing the company.

When there are suspicions of misconduct, the director's duty may require initiation of an internal investigation aimed at identifying culprits within the organization, bringing the corporation back into compliance, and mitigating damages to shareholders and the corporation.

#### Cooperating with Government Agencies

An inquiry from the SEC, IRS, US Attorney, or other governmental agency often prompts the corporation to commence an internal review to collect the relevant facts and possibly to work cooperatively with the government investigators in the hope of avoiding a full-scale government investigation and possible subsequent legal action. In recent years, the SEC and the DOJ have underscored the importance of cooperation by companies during the agencies' investigations. In response, many companies have attempted to appease the investigating entities by voluntarily disclosing material from internal investigations, including information protected by the attorney-client privilege and work product doctrine.

**SEC 21(a) Report.** In October 2001, the SEC released a report pursuant to § 21(a) of the Exchange Act indicating that companies will be afforded more favorable treatment, including no charges, reduced charges, or lighter sanctions, if they cooperate with the

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SEC investigation.<sup>1</sup> The report, arising from its investigation of Seaboard Corporation, indicated that the SEC would consider the following factors when evaluating how much to credit cooperation:

1. The degree of self-policing before the discovery of the misconduct, including compliance procedures in place to prevent the misconduct;
2. Whether the company promptly conducted a thorough review and then disclosed the complete results of its internal investigation;
3. Any remedial measures or internal controls that the company put in place to prevent a recurrence of the misconduct; and
4. The extent of cooperation with law enforcement authorities, including voluntary disclosure of information and full access to employees.

**DOJ Cooperation Guidelines.** In January 2003, the DOJ released a revised set of principles to guide prosecutors when assessing whether to prosecute a business organization.<sup>2</sup> The DOJ placed new emphasis on the role that a company's cooperation would play in the prosecutor's decision to bring charges or to negotiate a plea agreement. The report further indicated that prosecutors should consider the following factors when evaluating the adequacy and authenticity of a corporation's cooperation:

1. The corporation's efforts to identify culprits within the organization and willingness to cooperate in the investigation of its agents;
2. The corporation's refusal to protect or support culpable employees and agents;
3. The extent to which the corporation makes witnesses and evidence available to investigators;
4. Whether the corporation discloses the complete results of its internal investigation;
5. The corporation's willingness to waive attorney-client and work product protection; and
6. Whether, while purporting to cooperate, the corporation engaged in conduct that impedes the investigation.

**Identifying Claims the Corporation May Assert.** A corporation may conduct an internal investigation to permit the board of directors to determine whether the corporation has civil claims against any persons guilty

of misconduct and, if so, whether it is in the best interests of the corporation to pursue them. A shareholder demand or shareholder derivative action can prompt these types of inquiries.

**Protecting Position in the Marketplace.** A company may decide to initiate an internal investigation to encourage investor confidence and protect its position in the market. When allegations of misconduct are raised, the investigation may be used to address issues or dispel a cloud of suspicion. By quickly distancing itself from culpable employees, the corporation can demonstrate its good faith and decrease the negative impact of publicity.

## Control of the Internal Investigation

### Who Makes Decisions About the Investigation

To alleviate confusion later in the process, the corporation must identify the person or group within the organization responsible for assuming the role of decision maker at the outset of the internal investigation. In choosing the appropriate party, objectivity, impartiality, and independence are key factors. The conduct of the decision makers should not be at issue in the investigation. The persons selected should make such decisions as the direction and scope of the investigation and what steps to take on completion of the investigation.

**The Board.** The board may play the role of decision maker within the organization when the internal investigation was undertaken on the directors' own initiative, when the matter under review is particularly significant to the company, or when the conduct of senior management is being examined.

**Special Committee.** If the inquiry is expected to focus on senior officers or directors, the board should vest control in a special committee of individuals from outside the organization who can function with complete independence and objectivity. This is especially important if members of the board are potential culprits or if the internal investigation was prompted by a government investigation or shareholder pressure. The board may empower a special committee to direct the investigation and receive the report.

Additionally, the special committee may determine, after review, that dismissal of a shareholder derivative suit is in the best interests of the corporation. If the

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reviewing court determines that the special committee was independent, that it acted in good faith and conducted a thorough investigation, and that the committee had a reasonable basis for its conclusion, the court will defer to the committee's decision.<sup>3</sup>

**Audit Committee.** The audit committee is a standing committee of the full board with special expertise in the organization's accounting and financial practices. As part of its regular duties, the audit committee oversees external and internal auditors, reviews the preparation of financial statements, and monitors compliance with accounting policies. As a result, the audit committee is often an appropriate body to control an investigation. Its advantages, however, also make it more likely that the members of the audit committee could be implicated in the wrongdoing. If the inquiry uncovers improper accounting procedures, for example, it may indicate that the audit committee was negligent in the performance of its oversight duties.

**Management.** When the conduct being review occurred at mid to lower levels of the corporation and senior management is not implicated, the top officers of the company may control the investigation and make final decisions, although the company should keep in mind that, even when the company's officers and directors are completely disassociated from the suspected wrongdoing, shareholders or government investigators may question the impartiality and objectivity of insiders.

### Charter for the Investigation

The corporation should consider drafting and adopting a charter for the investigation. The purpose of the charter is to identify the body or person who will make the decisions, confer authority to conduct the investigation, and define the issues and the scope of the inquiry. The charter will give the investigators the power to obtain necessary facts and materials from corporate personnel. Its terms should refer to the corporation's need for legal advice on the pertinent issues and the likelihood of litigation so that the protections of the attorney-client privilege and work-product doctrines apply.

### Who Should Conduct the Investigation

Generally, internal investigations should be spearheaded by attorneys rather than by other professionals (*e.g.*, accountants or human resource departments). The use of an attorney helps to ensure the communications

and work product relating to the investigation will remain confidential. Still, organizations must choose whether to proceed with in-house lawyers or to employ outside counsel.

**In-House Counsel.** An investigation conducted by in-house counsel may be less costly and more efficient than one conducted by outside counsel. In-house lawyers are typically more familiar with the organization and the industry, thereby decreasing the learning curve. Because in-house counsel are employees of the organization, they may appear less credible and independent. Credibility is essential in gaining the confidence of investors and regulators when there are indications of wrongdoing.

There is an increased risk that in-house counsel may possess information that could make him a necessary witness or even a subject of the investigation. Similarly, because in-house counsel sometimes acts in both a legal and business capacity, the line between legal and business advice may be blurred, making preservation of the privilege difficult.

**Outside Counsel.** Outside counsel generally appear more independent and thus more objective than in-house counsel because they are not employees of the organization. However, when the organization is a major client of the outside counsel, the law firm may appear to have a conflict of interest in the internal investigation. This is especially true when the law firm has been involved with the subject matter of the investigation.<sup>4</sup>

Outside counsel must be independent of any interference from interested directors and officers. To this end, the organization may decide to retain a different law firm for the internal investigation than the one retained to defend the company in an SEC investigation. Outside counsel also tends to have more resources than in-house counsel. This can be a critical factor in large and complex internal investigations.

**Attorney-Client Privilege and Work-Product Protection.** The party ultimately chosen to conduct the internal investigation should make it clear at the outset that the investigation is not a mere fact inquiry, but instead, the primary purpose of the investigation is to convey legal advice to the company and to prepare for pending or threatened litigation. This approach will help to establish attorney-client privilege and the work-product doctrine for the communications and materials of the internal investigation.

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## Ethical Issues Relating to Employees

When counsel conducts an internal investigation, the client is typically the corporation, not the corporation's employees, officers, or directors.<sup>5</sup> In instances in which counsel represents both the organization and the employee, ethical and attorney-client privilege issues arise because the employees and the organization may have divergent interests. The divergent interests can lead to questions about the lawyer's ability to represent both under the applicable rules of professional responsibility, and when a lawyer has two clients in a matter, they share the attorney-client privilege. Therefore, it is imperative that counsel advise employees about whether they are a client of the law firm.

### Divergent Interests of the Employee and the Organization

An organization should thoroughly consider whether there is tension between its interests and its employees' interests and whether it is prudent for an employee to have separate counsel. To avoid problems and ambiguities, a lawyer conducting an investigation then must advise an employee whether the lawyer represents the organization alone or both the organization and the employee.

If a lawyer interviews an employee and does not make the position clear, the employee might reasonably believe that the lawyer represents him or her. If the lawyer later takes a position adverse to the employee, the lawyer faces the possibility of disqualification.<sup>6</sup>

An organization may want to divulge privileged information about an employee to a law enforcement agency to gain an advantage through cooperation. If it is not clear to the employee that he is not represented by the investigating counsel, the employee may attempt to block the privilege waiver. When the lawyer represents only the corporation, counsel should make clear that the privilege and any decision about whether to exercise it belong to the company. Counsel also should advise the employee to keep the interview confidential.

### Interview Memos

Interview memos should memorialize all warnings given to employees to avoid confusion regarding whether the employee was advised that counsel represented the company.

To enhance work-product protection, counsel should incorporate his thoughts and impressions into the interview memo. The memo should not be a verbatim transcript of the interview.

## Disclosure of Information Related to the Internal Investigation

When faced with allegations of misconduct, a company may release the results of an internal investigation to the public to encourage investor confidence and create the impression that it is serious about correcting misconduct. Similarly, as discussed above, many companies have voluntarily disclosed information protected by the attorney-client privilege and work-product doctrine to government agencies in an attempt to be cooperative and obtain leniency.

### Disclosing Documents to Government Agencies

Typically disclosure to adverse third parties waives the privilege and work-product protections. Thus, a company's voluntary disclosure of information from an internal investigation, including investigative reports, may result in a waiver. Courts are divided as to whether the privilege is preserved after disclosure of privileged documents to a government agency; however, most recent cases reject the selective waiver approach. When possible, it is generally good practice to enter into confidentiality agreements with government agencies before the disclosure of privileged documents. This will increase the likelihood that privilege and work product can be preserved.<sup>7</sup>

The following cases reject the selective waiver approach: *In re Columbia/HCA Healthcare Corp.*,<sup>8</sup> *In re Bank One Sec. Litig.*,<sup>9</sup> and *United States v. Berrgonzi*.<sup>10</sup> The following cases upheld the selective waiver approach when the disclosure was made pursuant to a confidentiality agreement: *Maruzen Co. v. Yakult Honsha Co.*,<sup>11</sup> and *Saito v. McKesson HBOC, Inc.*<sup>12</sup>

**SEC's Proposed Safe Harbor.** The SEC has recommended that Congress amend the Exchange Act to allow issuers to disclose privileged information related to a material violation to the government under a confidentiality agreement without waiving the privilege.

### Public Disclosure of Documents

The public disclosure of an internal investigation also may lead to a waiver of privilege protecting the materi-

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als used or created in the internal investigation. Because a company cannot guarantee that privilege will be preserved following the public disclosure of the results of an internal investigation, companies should weigh the value of the public statement against the risk of a waiver when evaluating whether to publicly release information gleaned from an internal investigation.

In *In re Kidder Peabody Sec. Litig.*,<sup>13</sup> the company publicly released the investigative report compiled during its internal investigation. The report summarized factual findings and employee interviews. In a shareholder derivative action, the court ordered the company to produce interview documents discussed in the report noting that “[d]isclosure of the substance of a privileged communication is as effective a waiver as a direct quotation since it reveals the substance of the statement.”<sup>14</sup>

In *In re Woolworth Corp. Sec. Class Action Litig.*,<sup>15</sup> the court found that public disclosure of an investigative report did not waive attorney-client privilege. The court noted that “[s]trong public policy considerations . . . mitigate against finding a waiver of the privilege.”<sup>16</sup>

## Lawyer Reporting Obligations Imposed by the Sarbanes-Oxley Act of 2002

Pursuant to its authority under § 307 of the Sarbanes-Oxley Act of 2002, the SEC issued rules to govern the conduct of attorneys appearing and practicing before it. The final rules, which became effective on August 5, 2003, require attorneys to report evidence of material violations of securities and other laws within a public company client. Counsel retained to conduct internal investigations have certain obligations under the rules.

### Up-the-Ladder Reporting

Rule 205.3 requires attorneys to report evidence of material violations of federal or state law “up the ladder” to an issuer’s CLO or the CLO and the CEO. If the attorney does not reasonably believe that the CLO or the CEO has responded appropriately, the attorney must report the violation to the issuer’s audit committee, another committee of independent directors, or the board of directors itself.

### Exceptions to the Reporting Requirement

Sarbanes-Oxley imposes a duty to report on attorneys who appear and practice before the SEC. An attorney

hired by a corporation to conduct an internal investigation regarding a material violation is bound by the rules. Rule 205.3(b)(5). If, however, certain criteria are met, he is not required to report up the ladder. An attorney retained to investigate evidence of a material violation does not have a duty to report up the ladder when:

1. The CLO retained the attorney who reports the results of the investigation to the CLO and the attorney and the CLO both reasonably believe that no material violation has occurred, is ongoing, or is about to occur and provided that the CLO reports the results to the issuer’s board of directors, a committee of independent directors, or a qualified legal compliance committee (QLCC); or
2. The attorney was retained by a QLCC and reports evidence of a material violation to the QLCC.

### Unrelated Matter

Although the rules do not say so explicitly, an investigating attorney who becomes aware of an unrelated material violation probably has a reporting duty with respect to the unrelated matter.

### Rule 205.3(d)

This section permits, but does not require, attorneys appearing and practicing before the SEC to reveal to the SEC confidential information without the issuer’s consent “to the extent the attorney reasonably believes necessary”:

1. To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
2. To prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury, suborning perjury, or perpetrating a fraud on the SEC; and
3. To rectify consequences of a “material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used.”

Because Rule 205.3(d) permits disclosure of an issuer’s confidential information without the issuer’s consent, there may be some tension between it and state

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ethical rules regarding the disclosure of privileged material. Attorneys wishing to reveal information pursuant to this rule should examine state ethics requirements.

### ABA Task Force Recommendation

There is also some tension between the permissive disclosure rules under Sarbanes-Oxley and the ABA's recent task force recommendation. In April 2003, the ABA Task Force on Corporate Responsibility issued a final report recommending that Rule 1.13 be amended such that the lawyer "may reveal information relating to the representation but only to the extent reasonably believed to be necessary to prevent substantial injury to the organization that is reasonably certain to occur."<sup>17</sup> Unlike Sarbanes-Oxley, the task force recommendation does not permit attorneys retained to investigate alleged violations to reveal confidential information, even where the organization refuses to act. At its annual meeting on August 12, 2003, the ABA adopted the task force's proposed amendment to Rule 1.13.

### Notes

1. Report of Investigation Pursuant to 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exch. Act Rel. No. 44,969, 2001 WL 1301408 (Oct. 23, 2001).
2. US Department of Justice, Principles of Federal Prosecution of Business Organizations (2003), available at [http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (Jan. 20, 2003).
3. *See, e.g.*, Kindt v. Lund, 2003 WL 21453879 (Del. Ch. May 30, 2003).

4. *See, e.g.*, In re Enron Corp. Sec. Derivative & ERISA Litig., 235 F. Supp. 2d 549, 668 n.103 (S.D. Tex. 2002) (questioning the propriety of a law firm's investigation of Enron when the company was a significant client of the firm).
5. *See* Model Rules of Prof. Conduct R. 1.13.
6. *See, e.g.*, Rosman v. Shapiro, 653 F. Supp. 1441, 1445-1446 (S.D.N.Y. 1987) (disqualifying counsel where a shareholder reasonably, albeit mistakenly, believed counsel represented him and the corporation).
7. *See* In re Steinhardt Partners, 9 F.3d 230, 236 (2d Cir. 1993) (finding waiver of attorney-work product when privileged documents were disclosed to the SEC but suggesting that the outcome may have been different had a confidentiality agreement been in place).
8. In re Columbia/HCA Healthcare Corp., 293 F.3d 289 (6th Cir. 2002).
9. In re Bank One Sec. Litig., 209 F.R.D. 418 (N.D. Ill. 2002).
10. United States v. Berrgonzi, No. CR-00-0505 MJJ, 2003 WL 21805228 (N.D. Cal. Aug. 5, 2003).
11. Maruzen Co. v. Yakult Honsha Co., No. 00 CIV 1079(RO), 2002 WL 1628782 (S.D.N.Y. July 23, 2002).
12. Saito v. McKesson HBOC, Inc., No. CIV A 18553, 2003 WL 31657622 (Del. Ch. Nov. 13, 2002).
13. In re Kidder Peabody Sec. Litig., 168 F.R.D. 459 (S.D.N.Y. 1996).
14. *Id.* at 470.
15. In re Woolworth Corp. Sec. Class Action Litig., 1996 WL 306576 (S.D.N.Y. June 7, 1996).
16. *Id.* at \*2.
17. ABA Task Force on Corporate Responsibility, Proposed Amend. to Rule 1.13, available at [http://www.abanet.org/buslaw/corporateresponsibility/delegate\\_reports/attachment1.pdf](http://www.abanet.org/buslaw/corporateresponsibility/delegate_reports/attachment1.pdf).



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