

What's New in the New Regulatory Environment?

What Directors Need to Know about Emerging Best Practices



Special Feature: When and How to Keep Notes and Minutes

SEATTLE-NORTHWEST CHAPTER
National Association of Corporate
Directors

May 18, 2004
7:15 – 9:00 a.m.

Today's Objectives

Scott Greenburg – Chapter President



- Introduce NACD
- Gain Insights into Today's Board Governance Issues
- Have an Opportunity to Exchange Views with Fellow Directors

The National Association of Corporate Directors



- Established in 1977, NACD is the only national organization dedicated to director education and improving board performance.
- 15,000 members and customers, from the Fortune 100 through smaller public, private, and non-profit companies
- Chapters in major cities nationwide

Upcoming



June 15, 2004

7:15 - 9:00 am

Emerging Audit
Committee Best
Practices After
SOX-

Charter, Process,
Rules and
Composition

www.nacdnw.org



Upcoming



SECOND ANNUAL DIRECTORS TRAINING ACADEMY

Adding Value through Legal, Ethical, and Responsible Governance: A Case-Study Approach

June 3-4, 2004 Seattle University School of Law Seattle, WA

This seminar will provide practical insights and the necessary tools to help make you a more effective board member or advisor. The training is designed for corporate directors, corporate counsel, senior executives and general counsel and will focus on providing an understanding of the oversight role and how board members can be more effective

Presented by the Center on Corporations, Law & Society at Seattle University School of Law and the Seattle University Albers School of Business

A promotional poster for the Second Annual Directors Training Academy. The top half features a photograph of the Seattle skyline with a large tree in the foreground. Text at the top reads: "THE CENTER ON CORPORATIONS, LAW & SOCIETY AT SEATTLE UNIVERSITY SCHOOL OF LAW AND THE ALBERS SCHOOL OF BUSINESS AND ECONOMICS PRESENT". The bottom half has a blue background with the event title "THE SECOND ANNUAL DIRECTORS TRAINING ACADEMY" and the date "June 4, 2004". Logos for Seattle University, NACD, NASDAQ, Perkins CDIC, and W&J are displayed at the bottom.

Founding Sponsors

Seattle-Northwest Chapter



What Directors Need to Know About Emerging Best Practices

Panelists:

Scott Greenburg

Neil McReynolds

Barry Kaplan

EMERGING BEST PRACTICES FOR BOARDS

Neil McReynolds

- **Public boards – Effectiveness, not just compliance.**
- **Trickle-down effect:**
 - Private company boards
 - Nonprofit boards
 - Trade Association boards

EMERGING BEST PRACTICES FOR BOARDS

- **What does this mean for boards?**
- **Board independence:**
 - **Board composition**
 - **Board committees**
 - **Non-executive leadership**
 - **Executive sessions**

EMERGING BEST PRACTICES FOR BOARDS

- **More structure:**
 - Board charters
 - Written board expectations
 - Codes of conduct
- **Board composition:**
 - Independence
 - Skills and experience
 - Financial expert
 - Age and term limits

EMERGING BEST PRACTICES FOR BOARDS

- **Board evaluations:**
 - More formal process for CEO
 - Board self-evaluation
 - Individual peer evaluation
- **Board education:**
 - Demands for more information
 - Company, industry, marketplace
 - Plant and office visits
 - More employee contact

EMERGING BEST PRACTICES FOR BOARDS

- **Board committees:**
 - Audit and Governance Committees
 - Executive Committee
 - Other committees
- **Board retreats:**
 - Why?
 - Board's role in strategic planning
 - How set up for effectiveness

EMERGING BEST PRACTICES FOR BOARDS

- **Meeting agendas:**
 - Board's input
 - Fewer reports and more discussion
 - Involvement of CEO and others

EMERGING BEST PRACTICES FOR BOARDS

- **Bottom line:**
 - Directors are spending more time, both inside and outside meetings
 - Board compensation

What's New: Cases

Scott Greenburg

- **Walt Disney (the Eisner/Ovitz bad faith case);**
- **Trace International Holdings (private director's duties);**
- **Hanover Compressor (governance requirement imposed by settlement); and**
- **Oracle Corporation (director independence—Special Litigation Committee)**
- **Beam v. Stewart (director independence)**

Background

- **Case Trend: Boards held liable for acts of management (public *and private* companies)**
- **Courts apply state law to corporate director conduct**
- **Fiduciary duties clarified (and perhaps extended)**

State Law on Board of Directors

- All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation.
- A corporation may dispense with or limit the authority of its board of directors by describing in its articles of incorporation who will perform some or all of the duties of the board of directors.
- *RCW 23B.08.010*

General Legal Standards (RCW § 23B.08.300)

Directors are required to discharge their duties :

- In good faith
- With the care an ordinary prudent person in a like position would exercise under similar circumstances
- In a manner the director reasonably believes to be in the best interests of the corporation
- Limited areas of explicit personal liability to Directors (e.g., unlawful distributions, securities, environmental, payroll taxes, Washington State employee case law)
- Business judgment rule: duty of care and duty of loyalty

RCW 23B.08.410

Duties of officers

- Each officer has the authority and shall perform the duties set forth in the bylaws or, to the extent consistent with the bylaws, the duties prescribed by the board of directors or by an officer authorized by the board of directors to prescribe the duties of other officers.

In re Walt Disney

In Re The Walt Disney Company Derivative Litigation, 825 A.2d 275
(Del. Ch. May 28, 2003)



- **Issue: Compensation and severance package of Michael Ovitz**
- **Ovitz left after 11 months with combined compensation of \$38 million cash and stock options valued at \$101 million.**

In re Walt Disney

Findings:

- **Lack of Good Faith: Directors knowingly made material decisions without adequate information or deliberation**
- **Delaware Supreme Court held the case against directors could not be dismissed:**
 - Directors saw no written contract and did not ask to see one
 - Final agreement was altered significantly from earlier summaries
 - Contract modified without board approval
 - No outside comp expert to analyze and compare
 - Directors left negotiations to Eisner and did not try to obtain better terms
 - Insufficient advance notice of agreement
 - Did not review source documents – Ovitz's employment agreement

In re Walt Disney

Lessons:

- **Duty of care requires informed decisions**
- **Exculpatory Provisions/Insurance: NOT COVERED IF BAD FAITH**
- **Possible liability: \$140 million**
- **Disney court: “directors who are supposed to be independent should have the guts to be a pain in the neck and act independently.”**

Trace International Holdings

Pereira v. Cogan, No. 00 Civ. 619 (RWS) (S.D.N.Y May 27, 2003)



- **Trace International Holdings, Inc. was private holding co, controlled by CEO Marshall S. Cogan. All directors were officers. No operations, majority ownership of two public entities (including Foamex).**
- **Relied on borrowings for cash. Technically insolvent or in the “zone of insolvency” from 1995 until bankruptcy in 1999.**
- **Bankruptcy trustee sued directors for Cogan’s self-dealing when in a “zone of insolvency.”**
- **Claims: excessive compensation, insider loans, illegal dividends, a lavish party, employment of Cogan’s daughter.**

Trace International Holdings

Findings:

- **Private directors liable:** “complete lack of any exercise of diligence in the performance of [their] duties,” combined with cozy relationship with Cogan was a breach (loyalty and due care).
 - Exculpatory provisions in articles did not eliminate liability for breaches of the duty of loyalty.
- **Controlling shareholder liable:** “[o]nce Cogan created the cookie jar – and obtained outside support for it – he could not without impunity take from it.”
- **Officers (who are not directors) liable:** discretionary authority in a relevant functional area and ability to cause or prevent the action can be liable. General counsel and CFO breached fiduciary duties because they could have prevented illegal loans and payments by notifying directors.

Trace International Holdings

Lessons:

- Private company directors should exhibit skepticism, diligence and a willingness to ask tough questions, fully inform themselves in a deliberate manner with respect to all board decisions (including decisions not to act), and seek the advice of independent experts when considering matters of material importance to the corporation or when considering matters that are outside the board's area of expertise.
- Private company directors should insist that adequate records be kept of board deliberations and actions, that board meetings be held regularly and that they receive all relevant and necessary information in advance of board meetings.

Trace International Holdings

Lessons:

- **Simply abstaining from board action on questionable corporate practices will not absolve a director. “[D]irectors will not be excused from liability if they either (1) knew about the challenged [transaction] yet unreasonably failed to take action; or (2) if they did not know, should have taken steps by which they would have been informed of the challenged expenditure.”**
- **The fact that a director had no self-interest, and did not stand to profit personally is no protection.**
- **Directors must scrutinize and fully understand any transactions between the company and any of its directors, officers, employees and their respective families, associates and affiliated entities.**

Hanover Compressor

Settled May 13, 2003, U.S.D.C. So. Dist. Texas



- Hanover provided natural gas compression, gas handling, etc.
- Securities claims for false financial statements and other false and misleading statements about the Company's operating performance: (a) \$16 million in revenue and \$2.6 million in net income recognized for a project in Q3 and Q4 should not have been recognized as it did not reflect the percentage of the project's completion; (b) Hanover's project partner replaced earlier than announced; (c) \$1 million paid for sham transaction documents to create revenue; (d) side letter to loan \$40 million (e) knowledge of delayed project completion; (f) financial statement for Q1-Q3 2001 overstated revenue and failed to disclose material facts, etc.

Hanover Compressor Settlement:

- **\$80+ million in cash, stock and debt**
- **Imposes restrictions on directors and officers concerning accelerated vesting of stock options and prohibits the use of derivative transactions to conceal insider stock sales**
- **Imposes detailed governance requirements**

Hanover Compressor

Lessons:

- **Courts focus on Directors, not just management**
- **Improved corporate governance is a solution**
- **It may be imposed (publicly) if not voluntarily adopted**

In re Oracle

In Re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. June 13, 2003, revised June 17, 2003).



- The Oracle board of directors formed a “Special Litigation Committee” to investigate alleged insider trading by four directors.
- The SLC had full authority to press, settle, or terminate the case.
- The SLC had separate counsel (35 meetings) and expert advisors, reviewed massive paper and electronic records, interviewed 70 witnesses, plus witnesses identified by plaintiffs.
- It concluded in 1,110 page report that Oracle not pursue the plaintiffs claims against four of its directors.

In re Oracle

Findings:

- Although the court found the committee went to great lengths it called “extensive by any objective measure,” the court was troubled by the interlocking relationships and the ability of the committee to be truly independent.
- Ties were so “substantial that they cause reasonable doubt” about the committee’s ability to “impartially consider” the issue.
- Ties flow out of personal or other relationships to the interested party.

Beam v. Stewart

Sup. Ct. Delaware, March 31, 2004



- **Derivative action claim on appeal against Martha Stewart for breach of duties of loyalty and care by illegal ImClone stock sale and mishandling publicity**
- **No demand was made that board institute the action, based on “demand futility” claim that board members were not independent or disinterested**
- **Procedural issue--Court focused on independence and distinguished *in re Oracle***

Beam v. Stewart

Findings:

- A stockholder may not pursue a derivative suit to assert a claim of the corporation unless:
 - “(a) she has first demanded that the directors pursue the corporate claim and they have wrongfully refused to do so; or
 - (b) such demand is excused because the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation.”
- Inquiry is director’s independence that is “reasonable” in order to excuse a presuit demand.
- Directors are entitled to a *presumption* that they were faithful to their fiduciary duties. In the context of presuit demand, the burden is upon the plaintiff.

Beam v. Stewart

Findings:

- A Director considered unable to act objectively with respect to a presuit demand if interested in the outcome or otherwise not independent.
- Interest may be shown by potential personal benefit or detriment.
- Director's decision must be based on corporate merits of the subject before the board, rather than extraneous considerations or influences.
- Is director capable of objectively making a business decision to assert or not assert a corporate claim against Stewart.
- Plaintiff failed to show sufficient facts.
- Books and records inspection that may have uncovered the facts to support a reasonable doubt.

Beam v. Stewart

Lessons:

- **Burden of proof shifts in SLC situation**
- **Independence is fact specific**
- **Courts will allow plaintiffs to look at corporate records to find facts supporting interest or lack of independence**
- **True independence is “cleansing”**

DOCUMENT ISSUES FOR DIRECTORS: Notes & Minutes

Barry Kaplan

■ ISSUES

- CREATION OF MINUTES OF
 - ❖ BOARD MEETINGS
 - ❖ COMMITTEE MEETINGS
- TAKING NOTES
- OTHER DOCUMENTS -
 - ❖ BOARD EMAIL PRACTICES
 - ❖ RECORDS OF “REPORTING UP”

THE LIABILITY LANDSCAPE

- **CLASS ACTIONS**
 - TYPICALLY IN FEDERAL COURT
 - FOCUSED ON DISCLOSURE
- **DERIVATIVE SUITS**
 - TYPICALLY IN STATE COURT
 - FOCUSED ON SUBSTANTIVE FULFILLMENT OF DUTIES

DERIVATIVE SUITS

- **THE NEW WAVE OF DERIVATIVE SUITS**
- **FOCUS-ADEQUATE SUPERVISION**
- **MAKES MINUTES/NOTES ETC. HIGHLY RELEVANT**
- **MAKES BOARD EVALUATIONS HIGHLY RELEVANT**

FORMAL DOCUMENTATION - BOARD MINUTES

■ WHY HAVE MINUTES?

- DOCUMENTS PROCESS, PARTICIPANTS, DECISIONS
- HOW MUCH DETAIL IS BEST?
- MINUTES OF BOARD COMMITTEES AND EXECUTIVE SESSIONS
- MINUTES OF SPECIAL COMMITTEES
- MINUTES OF SPECIAL LITIGATION COMMITTEES

■ WHO CREATES MINUTES?

- PRIVILEGE ISSUES
 - ✦ DRAFT MINUTES

DIRECTORS' NOTES - A PLAINTIFF'S TREASURE TROVE

- CASUAL, CANDID, SOMETIMES PERSONAL . . . AND COMPLETELY DISCOVERABLE
- “FILLS IN THE BLANKS” FOR PLAINTIFFS FROM THE MINUTES
- MARGINALIA ON BOARD BOOKS AND MATERIALS
- THE DISSENTING DIRECTOR

BOARD EMAIL COMMUNICATIONS

- **SAME PROBLEMS AS NOTES . . .
BUT INEVITABLE TODAY**
- **CREATES SEVERE PROBLEMS OF
PRESERVATION - PARTICULARLY
ON ANOTHER COMPANY'S
SYSTEM**

OTHER TREASURE TROVES FOR PLAINTIFFS

- **“REPORTING UP” TO THE AUDIT COMMITTEE UNDER SARBANES SECTION 307**
- **BOARD SELF EVALUATIONS OR PEER REVIEWS**

MINUTES AND NOTES - A SECURITIES LITIGATOR'S "BEST PRACTICES"

- MINUTES SHOULD BE PREPARED CAREFULLY - AND BE LIMITED TO PARTICIPANTS, PROCESS AND ACTIONS TAKEN
- NO MINUTES OF EXECUTIVE SESSIONS
- NOTES SHOULD BE AVOIDED

DOCUMENTS - A SECURITIES LITIGATOR'S "BEST PRACTICES"

- EMAIL DIALOGUE MAY BE UNAVOIDABLE BUT WILL CREATE SIGNIFICANT LITIGATION PROBLEMS AND RISK
- BOARD EVALUATIONS SHOULD BE CONDUCTED AND THEN NOT MAINTAINED - EITHER BY BOARD, COMPANY OR OUTSIDE CONSULTANT
- REPORTS UP SHOULD BE CONSIDERED NONPRIVILEGED

PANEL: Director's "Rights" (Duties)

Can Directors . . . ?

"Ask for More"

Undertake management and subordinate interviews

Hold executive sessions

Lift time limits

Rely on experts

X YES, ALL OF THE ABOVE



Questions and Answers Panel

Speaker Panel

Scott Greenburg

Scott Greenburg is a corporate/securities partner at the national law firm Wilson Sonsini Goodrich & Rosati, with more than 20 years experience in venture capital, public offerings, intellectual property and technology issues, mergers and acquisitions, complex commercial transactions and international product distribution. Among the companies that he has represented in well over 100 corporate transactions are Starbucks Corporation; Aventail Corporation; Maveron LLC; VoiceStream Wireless Corporation; Westin Hotel Company; Seattle SuperSonics; Western Wireless Corporation; Oh Boy! Oberto; and Cucina! Cucina!, Inc. He is President of the Seattle-Northwest Chapter of NACD and serves as a director for LockStream Corporation.

Neil McReynolds

Neil McReynolds is currently President of McReynolds Associates, Inc., a corporate governance consulting firm that advises corporations, non-profits, and trade associations on how to increase the effectiveness of their board. He is also a Strategic Director with Buerk Dale Victor LLC, a Pacific Northwest venture capital and private equity firm, and serves as an adjunct professor for the University of Washington MBA program, teaching Corporate Governance. Neil has served on nearly 50 boards throughout his career. He currently serves on the board of directors for Adinfontum, a BDV portfolio company. He is also the Board Chair of Washington Dental Service and board member for HomeStreet Bank.

Barry Kaplan

Barry Kaplan is a litigation partner at Perkins Coie and is Co-Chair of the Firm's Securities and Corporate Governance Litigation Practice Group. For over 15 years, his practice has been focused on representing public and private companies and their directors and officers in securities class actions and shareholder derivative litigation. He has represented many public and private companies in securities litigation in the Pacific Northwest and elsewhere including local companies such as Boeing, Immunex, Itron, US West, Alaska Airlines, Omega, Egghead, Digital Systems, Avenue A, and Primus. Barry serves as Chair of Perkins Coie's Sarbanes Oxley Committee. He has taught Securities Regulation at the University of Washington Law School. He is co-author (with Stewart Landefeld and Steve Yentzer) of Washington Corporate Law: Corporations and LLCs (LexisNexis/Matthew Bender).