

SPECIAL SECTION

Project: *Corporate Counsel (Compliance Readiness) Part II*

Corporate Governance Does Not End With Sarbanes-Oxley

Since the adoption of the Sarbanes-Oxley Act in 2002, public companies have devoted significant attention, time and resources to complying with its mandates, new SEC regulations and new rules adopted by the NYSE, AMEX and NASDAQ. However, in the wake of Enron, Worldcom, Adelphia and even Disney, shareholders and shareholder rights groups have pressured public companies to implement other policies and make other changes in the name of better corporate governance. These changes include stricter definitions of independence for directors, the separation of the CEO and chairman functions, limitations on executive compensation, majority voting requirements for the election of directors, restrictions on the number of boards or audit committees on which directors may serve and the elimination of staggered boards and poison pills. These areas of focus involve both the internal management of the company and potential impediments to the maximization of shareholder value.

The list of reforms that are endorsed by different shareholders and shareholder rights groups since the adoption of Sar-

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banes-Oxley has continued to grow. As a result of this growth, public companies now must also consider these reforms as they continue to comply with the legislative and market imposed obligations. In fact, shareholders of public companies have already successfully obtained shareholder approval for many of these policies. While not exhaustive, some of the more prominent shareholder corporate governance issues are summarized below.

1. Independence Of Directors And Committee Members

While the NYSE, AMEX and NASDAQ

have adopted definitions of independence (in addition to the definition contained in Section 301 of Sarbanes-Oxley), shareholder and shareholder rights groups continue to push for even stricter standards. As a common theme, these independence standards would require that no conflict of any type exist between the director and the issuer, whether through ownership of securities of the issuer, personal or familial relationships or agreements with the company. A concern that has been raised from the absence of a stricter standard is that the board of directors needs to serve better as an

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obstacle to management abuses, and that only by better separating the board members from any conflict situation can the board truly serve that role. If a stricter standard than that imposed by the NYSE, AMEX or NASDAQ is adopted by an issuer, the issuer may be required to disclose such stricter standard in its proxy statement and/or on its website.

In addition to the imposition of more stringent independence standards generally, shareholders and shareholder rights groups have sought greater independence of board committees, including the audit, compensation, nomination and ethics committees. While current regulations require that each member of the company's audit committee be independent and the NYSE, AMEX and NASDAQ also require that the company's nominating committee be independent, such requirements do not extend to other committees. As with other independence reforms, the impetus for change is to create more objective bodies to oversee certain management and board functions.

2. Separation Of The CEO And Chairman Functions; Lead Or Presiding Independent Director

With many public companies having a chairman of the board who also serves as the company's chief executive officer, the separation between management and the board of directors, which is charged with overseeing management, is blurred. Shareholder and shareholder rights groups have more recently sought to separate these functions in order to provide the board with increased independence and less control by management. In the absence of this separation, shareholders and shareholder rights groups have sought the designation of an independent director who would serve as lead or presiding director of the board. The responsibilities of this director might include:

- presiding over those sessions of the board attended by independent directors only and not by management directors or other members of management;
- convening meetings of the independent board members;
- presiding over the full board meetings when the chairman is unavailable;
- acting as spokesperson for the company when the CEO and/or chairman is unavailable;
- communicating the feedback of the independent directors to the CEO and when necessary, acting as liaison between the chairman and the board's independent directors on certain sensitive issues;
- analyzing the efficiency of board and committee meetings and recommending any necessary or desirable changes;
- retaining outside legal counsel or other advisors when he or she believes it is appropriate;
- when requested by management, attending and participating in meetings between management and major shareholders;
- receiving direct communications from shareholders;

- assuming primary leadership in managing corporate governance practices and policies in those situations in which it is inappropriate for the CEO or chairman to do so;

- assisting the chairman in considering board members' potential conflicts of interest; and

- advising and participating in the selection of committee chairs.

3. Compensation Policies

As evidenced by recent lawsuits involving excessive compensation packages for executives at several large public companies, including the highly publicized *Disney* case, shareholders and shareholder rights groups have made executive compensation a primary area of focus. Of particular concern have been golden parachute arrangements, the size of option pools, the rate at which options are granted and the standards for grants, and the size of cash bonuses. In fact, shareholders and shareholder rights groups have recently sought more frequent opportunities for shareholders to approve executive compensation policies. Issuers should expect that scrutiny of executive compensation will continue.

In the past, many directors relied on an analysis of publicly available information regarding compensation packages for senior executive officers at companies of similar size and industry. Many directors now believe that this type of analysis is inadequate and may expose them and the issuer to potential liability. As a result, compensation committees are more frequently retaining independent consultants to advise as to the appropriate level and type of compensation packages to be paid to a company's CEO, as well as other executive officers.

4. Majority Voting Requirement For Director Elections

Recently, shareholder proposals have sought to require companies to adopt by-law or charter amendments that would require a majority of votes cast rather than a plurality for the election of directors. Shareholders and shareholder rights groups consider this issue one of democratic principles. With plurality voting, where only board nominated candidates are up for election, a nominee only needs to obtain one vote in favor because shareholders can only withhold votes and cannot vote against a nominee. Under the majority rule standard, every nominee would need to obtain the approval of a majority of the votes cast. While many directors are currently elected by majority vote, this change could provide shareholders with greater opportunity to affect director elections.

5. Overboarded Directors

Shareholders and shareholder rights groups have also focused on the obligations of members of the board of directors to other businesses, whether as a result of offices that they hold or boards on which they sit. The stated concern is that for directors to fulfill their fiduciary duties properly they need the time to

devote to service on a board of directors. Time commitment has expanded as directors have sought to better fulfill their duties in the wake of the corporate scandals. If a director serves on several boards or has other significant responsibilities, shareholders and shareholder rights groups have sought to limit such people from being re-nominated or, even in certain circumstances, required them to resign from the board. Similar concerns have also been raised with respect to the number of audit committees on which a director serves, primarily as a result of the increased amount of work required to satisfy properly an audit committee member's obligations.

6. Staggered Boards And Poison Pills

Staggered boards are designed to limit the speed at which an entire board of directors can be replaced. However, while useful as an anti-takeover device, such arrangement also slows the pace at which shareholders can force change in the direction of the company. For both reasons, shareholders and shareholder rights groups generally are opposed to staggered board arrangements and have sought to eliminate such arrangements that were previously adopted. For similar reasons, shareholders and shareholder rights groups also are opposed to poison pill provisions. Shareholders have recently sought to repeal these provisions at many public companies and to impose restrictions on any new poison pill provisions without the company's first obtaining shareholder approval. As with staggered boards, poison pills provide defenses to public companies that might be targets of hostile takeovers. However, shareholders and shareholder rights groups view such provisions as fostering greater management entrenchment at the expense of shareholder value.

While the above list is not exhaustive of corporate governance issues that are being raised by shareholders and shareholder rights groups, it is illustrative of the fact that efforts are underway to change the manner in which publicly held companies are managed and controlled by their boards of directors. As a result, many public companies have implemented corporate governance policies that go beyond the requirements of Sarbanes-Oxley and address some of the issues raised by shareholders and shareholder rights groups. With institutional investors becoming more assertive in exercising their shareholder rights, it is important that corporate governance reform not be taken lightly. While such reform does not currently carry with it the legislative weight of the Sarbanes-Oxley Act, adoption of these reforms needs to be considered by all publicly-held companies and may also be instrumental in attracting institutional and mutual fund investors.